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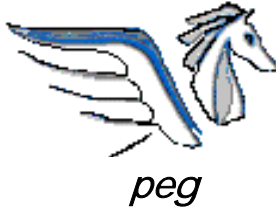
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Conference Proceedings

THE ECONOMIC COST OF TERRORISM: Indonesia's Response

**A Conference Organized by:
Centre for Strategic and International Studies (CSIS)
Partnership for Economic Growth (PEG) Project¹
Economic Law and Improved Procurement Systems (ELIPS) Project¹
United States Agency for International Development (USAID)**

**Tuesday, May 7, 2002
Shangri-La Hotel, Jakarta**



Submitted to:
USAID/ECG, Jakarta, Indonesia

Submitted by:
Nathan/Checchi Joint Venture
Partnership for Economic Growth (PEG)
Project¹
Under USAID Contract #497-C-00-98-00045-00
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May 7, 2002

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CONFERENCE PROCEEDINGS

“THE ECONOMIC COST OF TERRORISM: Indonesia’s Response”

**Tuesday, May 7, 2002
Shangri-La Hotel, Jakarta**

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AGENDA

**Conference on The Economic Cost of Terrorism:
Indonesia's Responses**
Shangri-La Hotel, Jakarta , Tuesday, 7 May 2002

| Time | |
|---------------|--|
| 08:30 – 09:00 | Registration |
| 09:00 – 10:00 | Opening Welcoming Remarks <div style="text-align: center;"> H.E. Susilo Bambang Yudhoyono <i>Coordinating Minister for Political and Security Affairs</i> </div> <div style="text-align: center;"> H.E. Ralph L. Boyce <i>Ambassador of the United States of America</i> </div> Keynote Address <i>Responding to Terrorism: Issues for Indonesia</i> <div style="text-align: center;"> Juwono Sudarsono <i>Former Minister of Defense</i> </div> |
| 10:00 – 10:30 | Coffee Break |
| 10:30 – 13:00 | Session I INDONESIA AND THE ECONOMIC COST OF TERRORISM <i>Analyzing the Cost of Global Terrorism to the Indonesian Economy</i> <div style="text-align: center;"> Mohammad Ikhsan <i>Director, Institute for Economic and Social Research, Faculty of Economics, University of Indonesia</i> </div> <i>Impact on Indonesia's External Trade and Competitive Position</i> <div style="text-align: center;"> William James <i>Senior International Economist Nathan Associates, Inc., PEG</i> </div> |

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| | <p><i>Perceptions of Indonesia's Investment Risk</i></p> <p>James van Zorge <i>Senior Partner</i> <i>Van Zorge, Haffernan and Associates</i></p> <p>Comments by Panel</p> <p>Djauhari Oratmangun <i>Director Economic Development and Environmental Affairs, Department of Foreign Affairs</i></p> <p>Marie Pangestu <i>Member, Board of Trustees, CSIS</i></p> <p>Patrick Alexander <i>Managing Director</i> <i>Batavia Management Investment</i></p> <p>Chair Hadi Susastro <i>Executive Director, CSIS</i></p> |
| 13:00 – 14:30 | <p>Lunch</p> <p>Luncheon Speech</p> <p><i>Indonesia's New Anti-terrorism Law</i></p> <p>Romli Atmasasmita <i>Director General of Administration Law Affairs</i> <i>Department of Justice and Human Rights</i></p> |
| 14:30 – 17:30 | <p>Session II</p> <p>WHAT IS TO BE DONE?</p> <p><i>Money Laundering, Terrorism and the OECD Standards</i></p> <p>Jerry W. Rowe <i>Forensic Accounting Consultant</i> <i>Mechanicsville, Virginia, USA</i></p> <p><i>ASEAN Countries Efforts to Curb Abuses of Their Financial System</i></p> <p>Koid Swee Lian <i>Department Head, Financial Intelligence unit</i> <i>Bank Negara, Malaysia</i></p> |

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| | <p><i>Indonesia's Bank Secrecy and Money Laundering Laws</i></p> <p>Abdul Gani Abdullah <i>Director General of Legislation Department of Justice and Human Rights</i></p> <p>Sutan Remy Sjahdeini <i>Chairman, Law Office Remy & Darus</i></p> <p>Comments by Panel</p> <p>S.B. Joedono <i>Chair, State Accounting Board</i></p> <p>Sunarjati Hartono <i>Professor, Faculty of Law Padjadjaran University</i></p> <p>Yunus Husein <i>Deputy Director, Bank Indonesia</i></p> <p>Chair Max Moein <i>Chairman, Committee IX House of Representatives</i></p> |

CONFERENCE

“THE ECONOMIC COST OF TERRORISM: Indonesia’s Response”

Organised by:

**Centre for Strategic and International Studies (CSIS)
Partnership for Economic Growth (PEG)
Economic Law and Improved Procurement Systems (ELIPS) Project
United States Agency for International Development (USAID)**

**Tuesday, May 7, 2002
Shangri-La Hotel, Jakarta**

Welcoming Remarks

Dr. M. Hadi Soesastro
Executive Director, CSIS

On behalf of CSIS, Dr. Soesastro welcomes all participants to the Conference on the Economic Cost of Terrorism. He also informs the participants the nature of the program, which is co-organised by PEG, USAID, and Elips II. Furthermore, he expresses his gratitude to all role players (e.g. speakers, moderators, and commentators) for being able to participate in a short notice. Having said so, Dr. Soesastro informs the audiences that H.E. Co-ordinating Minister and H.E. US Ambassador have to regretfully cancel their presence in the Conference. In addition, he mentions that there is a slight change in terms of speakers, because some of them are not able to attend the conference.

Furthermore, Dr. Soesastro reminds the participants that the objective of the program is to review the overall impact of terrorism on Indonesia. In particular, the main focus of this seminar is on the economic dimensions and cost of terrorism, which will also be used as a basis for further assessment. He briefly explains the plan of the seminar, particularly the issues discussed in each session. At the end, Dr. Soesastro thanks all participants for being able to attend the conference, expressing his wish that the program will be a fruitful one.

Hon. Stephen Mull
US Embassy

At the beginning, Mr. Mull (*Deputy Chief of Mission, Embassy of the USA, Jakarta*) expresses H.E. US Ambassador’s regrets for being unable to deliver his speech personally to the audiences, because he has to be in Makassar. In his remarks, Mr. Mull agrees that the issue of terrorism is a critical issue for all countries, especially for countries that have open and tolerant societies, extensive borders, and market economies. He also acknowledges the importance of this issue to country like

Indonesia. He believes that Indonesia and the US share some common features as mentioned earlier. Furthermore, Mr. Mull regards the support from the Megawati's government in the fight against terrorism, especially at the initial stage, as essential in building a global consciousness over the widespread implication of the attacks. In the following lines, Mr. Mull briefly notes that the economic impacts of terrorism on many economies are significant, especially on the initial days after the September event. He strongly believes that terrorism has increased the economic problems as part of the overall security problems.

Moreover, he also reiterates that the seminar is integral to the overall US policy in fighting terrorism, including the policy towards Indonesian, through which the US government aims at promoting a strong, united, democratic and prosperous Indonesia. He reckons that some might consider the US fighting against terrorism has been conducted at the expenses of some other values i.e. tradition, human rights, and democracy. Hence, he confirms that none of this accusation is close to truth. US efforts and supports to fight terrorism, on the contrary, are a way to ensure that democracy persists. The US so far has shown its firm commitment in assisting country like Indonesia gets back to its economic welfare through a lot of programs, organised by US institutions and government as well as through numerous international institutions.

However, in so doing, the US and Indonesian governments must work together. It is important for Indonesia to remain a full-partner in the war against terrorism, since Indonesia's continuing co-operation on fighting terrorism sends a strong signal to the financial markets and potential foreign investors about where it is headed as a country.

At the end, Mr. Mull reminds the audiences that the September attacks demonstrated with awful clarity the costs of intolerance and hatred. But he remains optimistic that democratic force and coalition will be victorious in this war. At the end of his remarks, Mr. Mull thanks and congratulates the organiser and participants, and wishes for a fruitful seminar.

Keynote Speech (Minutes)

Delivered by

Prof. Juwono Sudarsono
Former Minister of Defence

Mr. Sudarsono expresses his gratitude to be invited as keynote speaker. He reminds the participants that Indonesia is now in the difficult situation caused by the recent economic crisis.

He notes that there are three challenges Indonesia is facing:

1. Building and developing an accountable government in the future as a result of democratisation.
2. Providing sustainable economic—and more importantly equitable—developments, which have to address the wider audience of economy, especially the poorest of the poor. At this point, the broad-based equitable recovery is seen as essential to the formulation of sustainable economic developments.
3. Providing sustenance to the poorest of the poor. He notes that the crisis had put the poor in the harsh situation as a result of declining economy, which services of public goods can no longer be delivered to these people.

In his sense, he believes that the chief ministers on political are responsible to the first challenge, where ministers on economic should be responsible to the second, and ministers of social affairs is responsible in dealing with the third challenge.

Furthermore, he reiterates that the main problem in Indonesia today is that the government is not considerably strong. At the time we need an efficacy in governance, government is considerably at its lowest, and weakest. They cannot deliver. Therefore, what we are now confronting with is reconciling the issue of democracy and efficacy. However, he notes that this is perhaps the result or reflection of current nature of coalition government. In his observation, such a thing is perhaps the most debilitating aspect of the Indonesians in creating accountable and good governance and in dealing with the issues of building up economic and social recovery after the crisis.

Nevertheless, Prof. Sudarsono warns that Indonesia is now still in the transition period, where the issue of governance—both on good governance at the government and civil society—remains a big problem. He senses that the difficulty the people is facing in their daily life now—and coupled with the non-existing governance—creates a society like nowadays Indonesia. He describes some of the phenomena appeared in major newspapers in recent time clearly reflect the fact that poor people feels that globalisation is a disrupting and dislocating to the lives and livings of many nations. In addition, the people also reckon that too much foreign intervention to their life had only created a backlash.

Having said so, he insists that the main challenge ahead is definitely to deliver a basic social service especially to the Islamic community. Deliverance is the essential in preventing this fragile society from falling prey to the radicalism and terrorism. Therefore, Indonesia should be able to show the world that Indonesia is a good, democratic, peaceful Islamic country, and not an Islamic state. He is quick in reminding the audiences about the fundamental difference between the concepts of Islamic country and Islamic states.

In a bigger context, he also appeals for sustainable support and assistance from foreign countries to Indonesia, as he is optimistic that Indonesia can succeed its transformation period. Indonesia is in the threshold to find balance between recovery, reconciliation and security based on justice. This is the first experience of Indonesia over its history, and this exercise needs to be succeeded. He believes that the success of this transition depends on a strong—yet accountable, government. In this juncture, he believes that security authority should avoid the use of violence in dealing with social unrest in the country, yet be decisive in its efforts to stable the country.

Furthermore, he reckons that civil society should help strengthening the system of governance, but such an endeavour should be conducting through an accountable way. He notes that the importance of sense of priority within the authority is an initial and essential modality in dealing with these complex problems.

While Indonesia will be succeeded within 10 years time, hence, it must be noted that the Indonesian people are now having serious problem. The majority of population is still poor and even living under the poverty line. In that regard, he believes that the appeal of radicalism would be less attractive should we be able to deliver a sustenance to a poor society in a diverse nation like that of Indonesia.

We have to provide a certain degree of focus within the government. He believes that Indonesian' friends will continue helping Indonesia going through its major experience. Terrorism is not at all a relieving of the past, between the poor and the rich, but also a relieving from fear of the future like the potential widening gap between the poor and the rich brought by the nowadays changes in the world.

Finally he expresses his hope that this seminar will be able to identify and address the wide-ranging causes and impacts of terrorism, in relation to the existence of the cornered party, which are mostly poor and subsided. At this point, he believes that Islam in Indonesia in particular is syncretism and eclectic, and reflects the best example of tolerant society. As a tangible aspect of economics is definitely important in explaining the rise of recent terrorism, yet, he also reminds that intangible aspects are equally important. We have to move beyond the rigour of economic measurements, and goes to the quality of changes that occurs within society, and minding its impacts on society like that of Indonesian Islam. He hopes that this seminar would be a successful one, at least in mapping up the economic, social, political and security aspects of current exercise, not only in terms of quantitative dimensions, but equally important in terms of qualitative dimension. It must be noted that people are now expecting for some degree of stability, accountable governance, and more degree on the implementation of various policies.



CONFERENCE

on

THE ECONOMIC COST OF TERRORISM: INDONESIA'S RESPONSES

Tuesday, 7 May 2002
Shangri-La Hotel, Jakarta

Welcoming Speech

STEPHEN D. MULL

Deputy Chief of Mission
Embassy of the U.S.A.

Organized by
CENTRE FOR STRATEGIC AND INTERNATIONAL STUDIES
with the support of
USAID

Welcoming Speech

Stephen D. Mull

Professor Juwono Sudarsono, CSIS Director Hadi Soesastro, members of the press and other distinguished guests.

I am pleased to have the opportunity to open this important CSIS seminar on the economics costs of terrorism and to welcome such a distinguished group of participants. Terrorism is a critical issue for all countries, but all the more so for countries like the U.S. and Indonesia that have open and tolerant societies, extensive borders and market economies

There is a strong common interest between the U.S. and Indonesia in fighting terrorism, and we in the United States are gratified by the commitment of President Megawati's government to the struggle. We are pleased to work with CSIS on this seminar that will focus attention on the common economic interest that all market economies share in ending the scourge of terrorism.

Just days after the horrible attacks in New York, Washington, and Pennsylvania, President Megawati visited the United States and met with President Bush at the White House. She was one of the first foreign leaders to do so. President Megawati expressed her deep condolences to President Bush and the American people for the tragedy of September 11 and Indonesia's commitment to fight terrorism.

By the time of President Megawati's visit to Washington, it was already clear that the September 11 attacks were not only a blow against open societies and the principle of religious tolerance. They were also a full frontal attack on both the U.S. and global economies, and I remember the deep sense of gloom about Indonesia's economic prospects in the immediate aftermath.

Of course, Indonesia's economy was already slowing by last September. But the September 11 attacks made the situation worse. The angry demonstrations at the Embassy and threats against Americans that followed the coalition's response against the Taliban regime spooked both the financial markets and potential foreign investors. The narrow lens of international press coverage of the demonstrations compounded the damage. In the six weeks after the attacks, the rupiah depreciated by almost 15 percent, and by the end of October, the Jakarta Stock Exchange composite index was closing well under 400. More directly, since the U.S. is Indonesia's largest export market, exporters here were worried that the attacks would deepen America's recession and further reduce the demand for Indonesian products.

Seven months later, I'm happy to report both the American and Indonesian economies have turned out to be more resilient than many economists thought. But this relatively good news shouldn't lull us into complacency. Terrorism brings with it direct and indirect economic costs ranging from lost foreign investment to decreases

in tourist arrivals to higher security costs for it almost all companies. These are costs that Indonesia can ill afford.

This seminar will present concrete results of research on just how high these costs have been for Indonesia. You will also discuss what specific actions may be taken to cut terrorists' financial supply lines, what can be done to enhance Indonesia's capacity to analyze and understand both domestic and international terrorism, and how international aid agencies might rethink their approaches to development assistance in light of the ugly reality of terrorism.

Positive steps taken now, based on such information and analyses, will surely help Indonesia to confront terrorism in all its forms and boost Indonesia's economic development prospects.

This seminar on the economic costs of terrorism is integral to U.S. policy towards Indonesia. The US government's goal is to promote a strong, united, democratic and prosperous Indonesia. It is to work with the Indonesian Government and people in addressing common interests, including the need to fight terrorism, promote security, and foster economic growth. Working together to fight terrorism is critical to the achievement of all our common goals, including economic prosperity.

Some people have suggested that in the war against terrorism, the U.S. has put aside other values and goals such as strengthening democracy, protecting human rights and promoting economic prosperity. Nothing could be further from the truth. Our challenge is to adopt security policies that defend those principles on which our country is based without undermining them. It is a complex task, an assessment that I know our Indonesian friends share as they consider drafting their own anti-terrorism legislation. But I am confident that we democracies will find the right balance by remaining true to the values of democracy and human rights.

In addition to protecting and preserving our democratic conditions, we must find a way to guarantee the sense of security that terrorists seek to destroy. Insecurity and the possibility of terrorist attacks discourage investment, including foreign investment. This is why it is important to Indonesia's success that it remain a full partner in the war against terrorism. Indonesia's continuing cooperation on anti-terrorism sends a strong signal to the financial markets and potential foreign investors about where it is headed as a country.

The U.S. supports Indonesia's economy in the IMF and other international financial institutions, in the Paris Club, and through our extensive bilateral economic relationship. The U.S. is Indonesia's top export market. Indonesian companies shipped \$7.2 billion in products to the U.S. last year --mostly manufactured products that provide jobs for hundreds of thousands of Indonesian workers. U.S. companies operating in Indonesia, like General Electric, Exxon Mobil, and hundreds of smaller firms, pay millions of dollars in taxes each year, transfer new technology to Indonesia, and through world-class training programs, improve Indonesia's human resources.

The U.S. also stands ready to assist the Indonesian Government its efforts to advance its important counter-terrorism initiatives. The U.S. Agency for International Development supports programs that build strong and open democratic institutions,

strengthen the rule of law, and promote vigorous and sustainable economic growth. In conjunction with the Asian Development Bank and AUSAID, USAID has offered to help implement the new anti-money laundering law and establish the Financial Transactions Center that will investigate suspicious transactions.

Along with assistance from Indonesia's other development partners, support from the U.S. gives Indonesia a chance to put into place the underlying laws and institutions to fight terrorism more effectively. Potential investors will take note of improvements in Indonesia's institutions, and calculate that their investments will be safer as a result. If the Government seizes this opportunity, as I believe it will, every Indonesian's security and economic prospects will improve as a result.

The tragedy of September 11 affected the entire world and demonstrated with awful clarity the costs of intolerance and hatred. Since the attacks, more than 180 countries, including the U.S. and Indonesia, have joined together to rid the world of the scourge of terrorism. For Indonesia, as for many countries, the stakes are high. But I believe that by working together, we can foster tolerance, prosperity, and democracy in all countries, and win the fight against international terror.

I wish all of you a very successful seminar as you discuss these important issues. Thank you very much for the opportunity to speak to you today.

CONFERENCE

“THE ECONOMIC COST OF TERRORISM: Indonesia’s Response”

Organized by:

**Centre for Strategic and International Studies (CSIS)
Partnership for Economic Growth (PEG) Project
Economic Law and Improved Procurement Systems (ELIPS) Project
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**Tuesday, May 7, 2002
Shangri-La Hotel, Jakarta**

SESSION I

Indonesia and The Economic Cost of Terrorism

Chair: Dr. M. Hadi Soesastro

Dr. Soesastro opens the session at 10: 35 AM, and then briefs the audiences the mechanism and flows of Session I. Having briefly explained the mechanism, he introduces all three speakers and commentators of this session.

1. Impacts on Indonesia’s Trade and Competitive Position

William James

James discusses briefly on the economic impacts and costs of terrorism. Definitely, he believes that the first economic impact of terrorism on Indonesia is on the Indonesian export side. The second one is of course on services, where the reluctance of people to travel by air had impacted the service sectors, most notably tourism, and escort service. Also the impact on the oil price is recognisant. On a longer-term effect, the issues are continuity of investment to Indonesia, and budgetary issue.

James is convinced that the best way to approach the question of impacts of terrorism on one’s economy is by raising several intermediate questions. What would be the cost to Indonesia if it were to be perceived as a “Safe Haven” for terrorist groups? Would Indonesia have been able to pull of the Paris Club II rescheduling of official external debt, if it had not responded positively to the campaign against terrorism? Would Indonesia have been able to experience each improvement in macroeconomic condition if it had been unwilling to support the US in the wake of the attacks? Those are among the intermediate questions that we have to raise in assessing the impacts of terrorism on the economy.

In particular case of Indonesia, his observation shows that Rupiah is appreciated 10 % this year, and other good signs to the economy. Furthermore,

he also briefly notes that the September attacks and its subsequent military and political response were taken place against the backdrop of an already bleak global economic outlook i.e. synchronised economic slowdowns in all major industrialised region and so forth.

Most of the export goes to the US is non-oil, and the US remains the biggest market for the Indonesian non-oil products. Data shows that even China's export to both US and Japan is relatively declining in the third quarter of 2001. Data also informs that Indonesia is not hit as bad as other ASEAN economies because of its product diversity and natural resources.

Compared to other countries in the region, Indonesian position in terms of export growth is relatively better in non-oil sectors.

On the import side, year 2001 saw a bad year for the economies in the region. China, is the market where demand is growing, but Indonesia cannot make the best of this opportunity.

On the export-import table, it is clearly shown that yearly basis has its own pattern. After 911, it is evident that there is an acceleration of economic decline especially in the third quarter.

Indonesia's inflation is considerably too high. It means that the real income of people is being eroded, and it poses a serious problem. Unlike Argentina where such a situation resulted in a series of social unrest, but Indonesia's monetary regime had prevented this Argentinian case from taking place in this country. However, it makes Indonesia's economy remains vulnerable.

Year 2002 saw a better sign of economy, where growth is slightly grown. Many major economies, including the US, had rebounded from recession. Although economy is better, no capital formation is seen in the US. The Dollar is strengthened but the US deficit remains continued. It is possible that this situation can lead to a difficulty in the future. Indonesian economic condition also resembles the global phenomena.

Three challenges for Indonesia:

1. The China Challenge, especially in labour-intensive sectors like textile
2. Challenge from Preferential Trade Arrangements (i.e. tariff discriminations)
3. Challenge from new forms of protection e.g. counter-veiling trade, quota etc.

II. Perceptions of Indonesia's Investment Risk

James Van Zorge

Van Zorge discusses on perception of risk. He analogously shares his personal reflection on the way the traffic in Jakarta works and the investors' perception. Investors basically look for stability, and often disrupted by the euphoria as

seen from the outside or from distance. However, from the inside, it is obvious that things are not as bad as it seen.

Investors are driven by two factors: sentiments and fundamentals. In his observation, Van Zorge notes that the farther away the investor, the more that investor's outlook is driven by sentiment, not fundamentals. However, it must be remembered that perception is not uniformed across all investors. Some may look at the global landscape, but some request and scrutinise the details, which often not available in Indonesia.

There is a problem with in-depth knowledge of Indonesia's political and economic nature from foreign managers in understanding the dynamics of Indonesia's politics. Some of them simply judge things with curiosity because they believe the authority always have hidden agenda.

On the fundamental side, they often look into the policy in general. What is important to these investors is definitely logical and clarity in rules of the game. Furthermore, they look into the application of these rules in a sensible and consistent way. It is obvious that once the fundamental is declining, for the long-term investors, the first to pull out is the ones deal with labour-intensive sectors.

In responding to numerous scenarios, there are at least two alternatives for investors to react: (1) leaving the country immediately, or; (2) wait-and-see, if the hassle is not on the fundamental side. Now, where is Indonesia today?

As he sees, Indonesia is in the "yellow-light". It is an improvement because when Megawati came to the office, the light was red. Therefore, her relative success in dealing with security issues is one of the reasons to this improvement. But the potential threat is still there. The Megawati's government should not feel complacent with this success.

III. The Economic Costs of Terrorism: Issues and Implications

Dr.Mohammad Ikhsan

He begins his session by explaining the general background to the issue of terrorism, and its economic impacts. He believes that there are some limitations the writers are facing in writing the paper. First there is no clear definition of terrorism as he revealed at least 100 definitions widely ranging from one extreme used by regime—juxtaposed it with the secessionist movements, to the other extreme. Yet, for many scholars, terrorism is often perceived as the spread of fears and terrors.

Second, when assessments were conducted, there are flowing events going on along the time of assessment. It is therefore difficult to isolate the events from each other. Thirdly, there is a time lag effect by the time the event took place, and its impacts. Lastly, there is a need to distinguish between the crime and terrorism.

He also shares some of the possible channels in the transmission of the issues to one economy:

1. The confidence Channel causing reduced spending, where this effect can be spread out across the world economy. It will affect the perception and confidence of both consumers and producers. Hence, it is not uniform as some sectors might be benefited from the issue of terrorism.
2. Response from the Financial Market, which is very much dependent upon the perception. Two conceivable impacts are on: (1) Asset price drop, and; (2) borrowing cost will be higher
3. Trade and Commodity Market Channel, where demand for exported goods reduces, and as a result the price of commodities will fall, implying a more intense competition among developing countries, while debt costs remains
4. Tourism channel, in which he believes that tourist flows will be affected and as a result, tourist-related industries were hit. Also, the tighter security procedures hamper tourism to grow further.
5. Transportation and Insurance Channels, in which terrorism had cause higher cost for covering the transportation and insurance sectors.

Having described the channels, Ikhsan reviews the empirical evidence as to whether or not the 911 reduced the confidence on Indonesia? Data shows, on the contrary to the previous speakers, Indonesia's economy is shown a difficult dynamics. Hence, he found that better domestic economy had strongly affected the improvement of the economy rather than the impacts of terrorism.

In the Commodity market channel evidence, he shares William James' view that there was a reduction in terms of imports in the US (data from US customs). Also a number of tourist in Indonesia decline significantly in the end of 2001. The decline is around 10-15 million USD.

The overall estimates on the domestic economy, it is small relative to total GDP or the crisis of 97-98. Then, why is the cost of terrorism is relatively small? Perhaps, it is because terrorism as that of 911 happens once, and may be because the effective response from global community towards the issue of terrorism. Secondly, it is apparent that crisis has yielded a better policy and better co-ordination, as shown in the fiscal policy co-ordination among the G7 countries. Third, the issue of quick and short-span operation in Afghanistan. Lastly, Indonesia is not a target of terrorism.

What are the solutions, especially suggestions from the economists? The possible solutions for reducing terrorism that can be undertaken are as follow:

1. Find the underlying causes of terrorism. There is no correlation between the harsh economic and social background (i.e. education) and the appeal to terrorism. This was taken from recent studies undertaken by Krueger et al.
2. Where poverty perhaps contributes to the radicalism, yet, he believes that democracy is one other possible way to delve the issue of terrorism. Therefore, economic improvement, poverty alleviation and social

betterment in fighting corruption should be followed by a political democratisation.

In conclusion, it is believed that quantitatively, the terrorism impacts less significantly to the concerned economy.

COMMENTATORS

1. Dr. Djauhari Oratmangun

He starts by thanking the organisers for inviting him speaking this morning. He believes that the issue of globalisation is a key link that connects the whole gamut of terrorism and economic situation. Events occur in the US had impacted in other countries including Indonesia. In his views, he confines that terrorist attacks in the US have affected the global economy and production.

There are factors that need to be examined:

1. The impact of terrorism not only to the US economy, but also to the global one.
2. The incident had directly caused the deterioration of confidence, especially in financial market.
3. The incident had caused a policy change in major economy, in which these countries became more accommodative to developing economies.

The impact on Indonesia is quite significant. However, it must be acknowledged that Indonesia is among the country that calls for the more active involvement of the US to the issue of terrorism. Indonesia explores and uses every channel available in fighting terrorism, including the UN.

Specifically, Dr. Oratmangun comments on the relationship between Indonesia's response to terrorism and result of Paris Club III. In that regard, he mentions that Indonesia is still facing two immediate problems, namely poverty and debt. Hence, Indonesia is also facing three challenges namely the democratic transition, establishing good governance, respect for human rights, and calls for fighting terrorism. Yet, he believes that poverty and debt are the main drivers to the success of Paris Club III. Indonesian intentions in discussing its own economic condition with external actors are merely based on concerns to alleviate poverty, and open access in major economies to Indonesian products and commodity. Second, we have to deal with new issues in return for the co-operation in poverty eradication. With this in mind, he believes Indonesia can succeed its attempts in appearing better.

2. *Dr. Mari Pangestu*

She would like to raise five issues and challenges. She also believes that we should not be complacent to the opinion that terrorism has minor impact on economy;

External challenges:

1. Bear in mind that since Indonesia is less competitive than other economies, the question for Indonesia is then can we actually be participating in increasing our export to major economies. We could not enjoy of growth in US, and then, are we now going to be in position to respond to the

economic upturn. There are some concerns over capacity, and so forth. In that sense, she believes that China challenge is very real.

2. In the past, we were able to separate economic from other issues, but not after 911. She describes that many arrangements had now been put to halt such that of APEC, and even the WTO Doha Round. 911 event has been galvanising many complex issues into a single perspective. She does not have any clue yet as to the extent to which terrorism will galvanise the economic-related issues i.e. connecting response to fighting terrorism with economic transaction or alienation.

Internal Challenges. As for internal challenges, she outlines some particular points, as follow:

1. The issue of restoring confidence in Indonesia is a complex one, which needs more than just tax reforming and so forth. It must start with security, coherent policy, economic consistency and so forth. She however counter-argues Juwono on the front that economic down/up-turn is relative. What we are looking now is merely a resumption of confidence, and investment, but it may not persist long.
2. The process of recovery is going to be a long one, and it is not realistic to have deadline of three years in dealing with overall economic problems of the country. She believes that while Indonesia knows the end of the tunnels, yet, it needs more than 10 to 20 years before we can reach that end. Many things need to be done, realistically. In that sense, process becomes more important, and small step is essential in that direction.

3. Mr. Patrick Alexander

In passing, looking from non-economist's perspectives, he notices that economic life has been as the same as before the Sept. 11, where the US was also faced with the bad recession issue. Yet, as in the case of Indonesia, he strongly believes that although better signs appear such as growth, yet, Indonesia needs more than just 3.9 % of growth. It needs to be back to pre-crisis growth in order to sustaining the national development.

Henceforth, he is also cognizant that for the investors, current situation is a perfect ripe situation. There are a number of issues that need to be addressed thoroughly, namely legal issues.

Perception on Indonesia is apparently paint by the fact that Indonesia is lack of leadership. This at least appear and as reflected in major newspaper in the world. But he concurs that Indonesia has been able to tackle the issue of security. Yet, thing that needs to be rectified is the perception of foreigners on the image of Indonesian Muslim society. There should be an intensified exchange between Indonesian and Western governments on this particular issues, in order to tamper the inaccurate reportage on Indonesia.

DISCUSSION

Q1. Hasnan Habib

1. There is no way to direct the attack with dynamics of Indonesian economy in the aftermath of 911? What if the attacks were directed at other countries like Japan or Germany, would the impact be the same?
2. To Ikhsan: I don't completely agree with your statement that we must separate crime from terrorism? Terrorism itself is a crime. It is a crime against humanitarian. Yet, I agree that domestic condition is more applicable to explaining the economic dynamics.
3. To Van Zorge: Why the US is more unilateral? What really persuades or dissuades investors from investing in Indonesia?

Q2. Sadju Praptohatmojo

1. The theme of this conference is the economic cost of terrorism, yet there are questions that are yet answered. What is terrorism? What causes terrorism? I personally believe that injustice is the prime cause of terrorism!

Q3. Melly G. Tan

2. She confines that deep sense of injustice is a cause to terrorism.

Answers/Responses:

1. William James: Indeed, I can't fully measure the economic impacts of terrorism. It will be difficult to separate problems from one another. In his view, he believes that Osama had carefully calculated the impact the attacks may be posed by attacking the US.
2. Van Zorge: Government's inaction to curtail some of radical groups had shattered the image of this country in front of other countries.
3. Ikhsan: what I mean by crime is merely an ordinary petty crime. He still believes that poverty alone is not the main issue that causes terrorism. It should be accompany by other issues such as political uncertainty and injustice. Yet, question of justice is a slippery one, depending on the interests and side you are taking with.
4. Djauhari Oratmangun: I agree on the issue of social injustice.
5. Hadi Soesastro: I don't think there is a single cause for individuals or group of individual to be angry and commit a terrorist act. There are also some definitions of terrorism, and Mahathir's definition perhaps represents one of the correct definitions.

Q4. Hartomo Reksodiputro

1. The UN should be more decisive in the conduct of anti-terrorism. Do you think that the UN would have more dominant role on the issue of UN restructuring?
2. Attacks on the UN basically hurt the US pride.

Q.5. Deplu

1. How is the prospect of Doha round in the future, and what kind of suggestions Pangestu can be shared for Indonesia in order to cope with uncertainty in global economy and WTO round?

Q.6. Deplu

1. The danger behind Mahathir's definition, because it does not involve state-terrorism.

Answers

1. Mari Pangestu

Indeed, it is difficult to reach consensus in the Round. The issue in Doha is much more complex compared with that of Uruguay because many issues are beyond the trade-related ones. We have no capacity to deal with such problems. Yet, it requires more co-ordination and co-operation among many sectors and branches of government.

At 1300, Dr. Soesastro adjourns the Session and thanking all speakers and participants for this excellent session.



CONFERENCE

on

THE ECONOMIC COST OF TERRORISM: INDONESIA'S RESPONSES

Tuesday, 7 May 2002
Shangri-La Hotel, Jakarta

The Economic Costs of Terrorism: Issues And Implications

Mohamad Ikhsan

M. Chatib Basri

Neil Mc Mullen

Organized by
CENTRE FOR STRATEGIC AND INTERNATIONAL STUDIES
with the support of
USAID

THE ECONOMIC COSTS OF TERRORISM: ISSUES AND IMPLICATIONS

Mohamad Ikhsan, M. Chatib Basri and
Neil McMullen/LPEM-FEUI and IRIS

What is terrorism?

- ❖ About 100 diplomatic or scholarly definitions exist.
 - ◆ In the late of 19th century, Russian and French anarchists proudly used the term of terrorism to describe any movements against the state.
 - ◆ US State Department definition is:
 - *The term "terrorism" means premeditated, politically motivated violence perpetrated against non combatant targets by sub national groups of clandestine agents, intended to influence the audience.*
 - ◆ Definition used commonly by scholars tend to put emphasis on the intention of terrorists to cause fear and terror among a target audience with the aim of persuasion that transcends the harm caused to the immediate victims.

Possible Channels

- ❖ *The Confidence Channel causing reduced spending.*
 - ◆ This effect can be spread out across the world economy.
- ❖ *Financial Market Responses*
 - ◆ Asset prices drop
 - ◆ Borrowing costs will be higher
- ❖ *Trade and commodity market channel*
 - ◆ Demand for exported goods reduced.
 - ◆ As a result, price of commodities will fall, implying a more intense competition among developing countries, while debt costs remain.

❖ ***Tourism Channels***

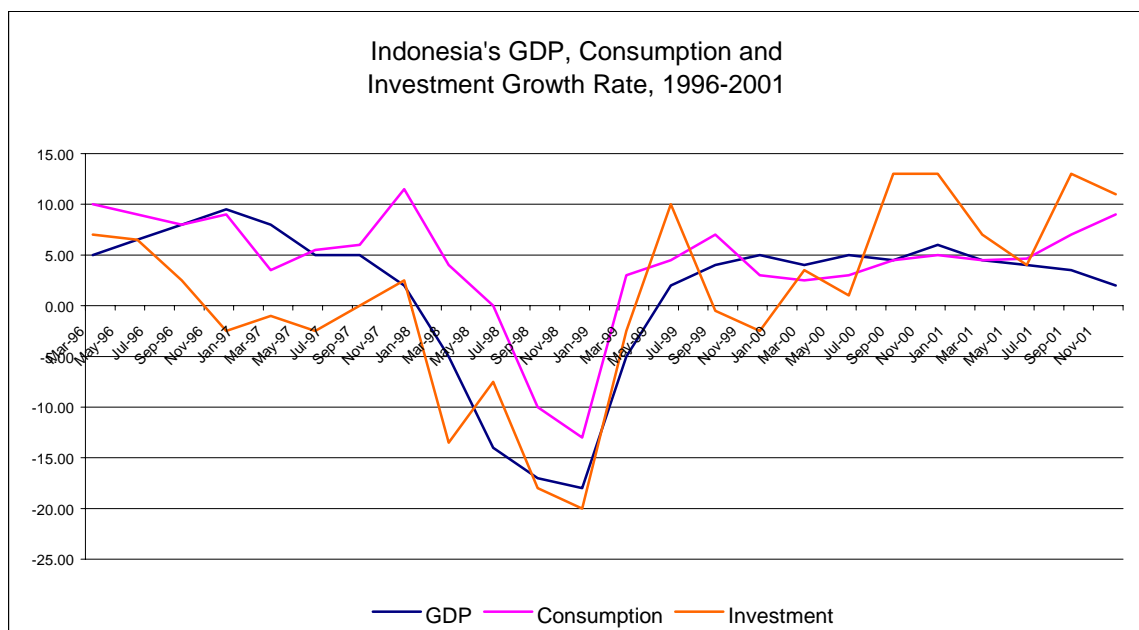
- ◆ Tourism flows will be affected and as result tourist and related industries will be hurt.

❖ ***Transportation and Insurance Channels.***

- ◆ Terrorism would increase cost of transportation.

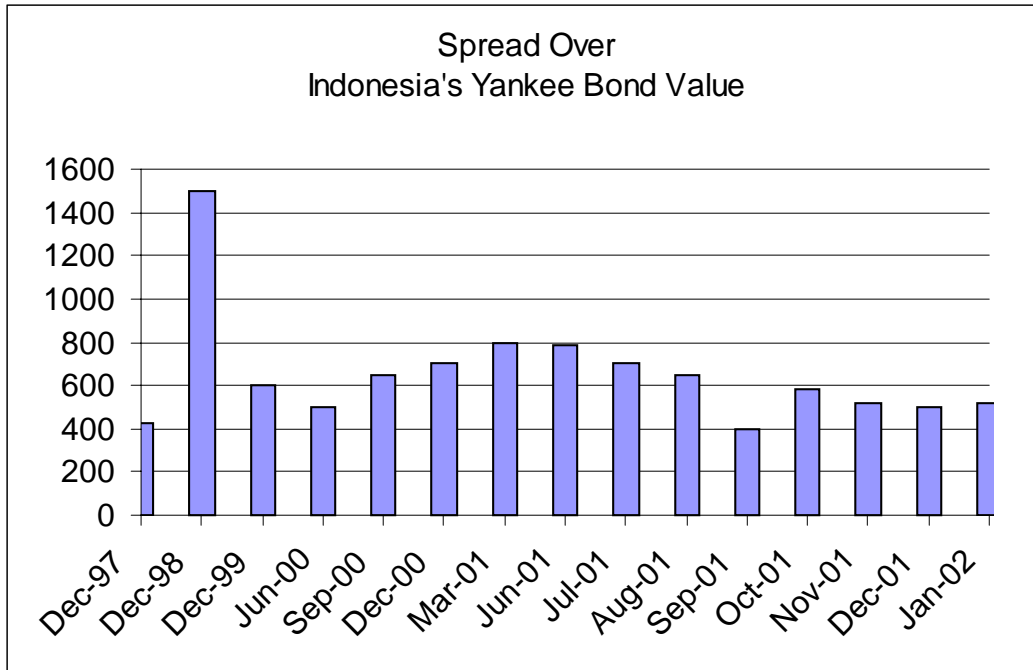
Empirical Evidences:

Did 911 reduce the confidence about Indonesia?

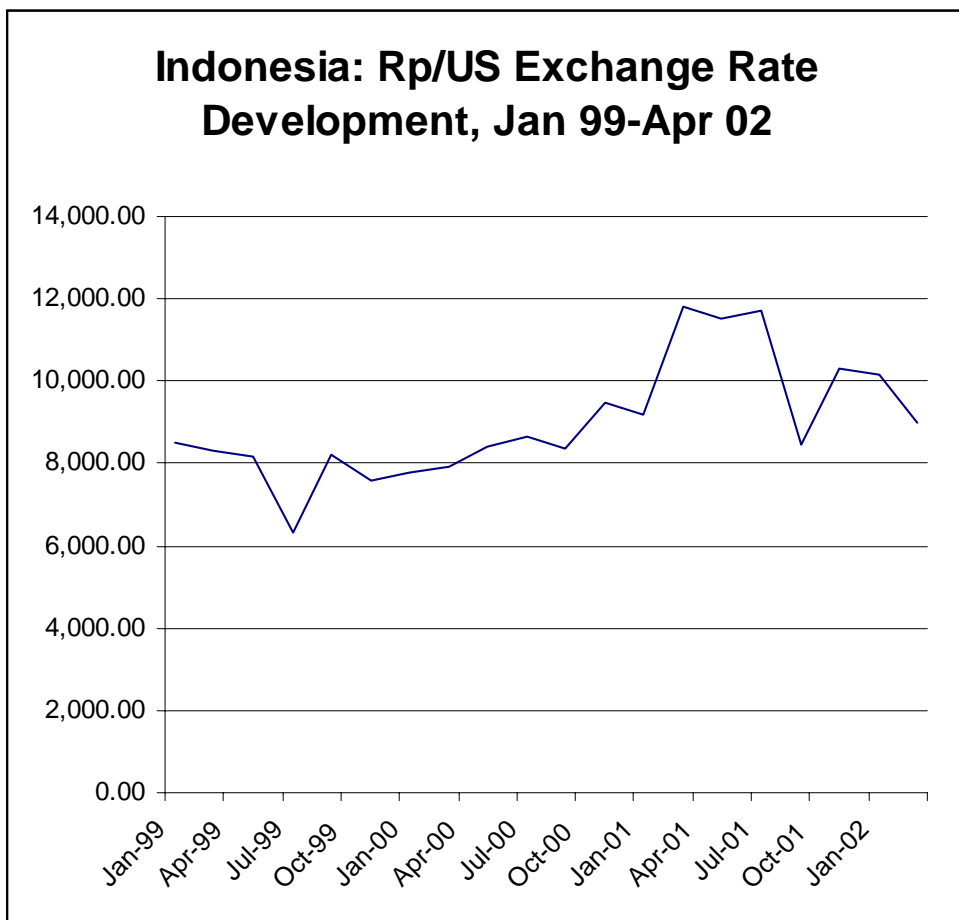


This graph shows that there was hardly any correlation between the 911 attack and investor confidence towards Indonesia. It seems that domestic problems play more important role in determining investor confidence.

In addition, spread of Indonesia Yankee bond tended to improve after the attack.



Did the 911 attack affect domestic financial market?



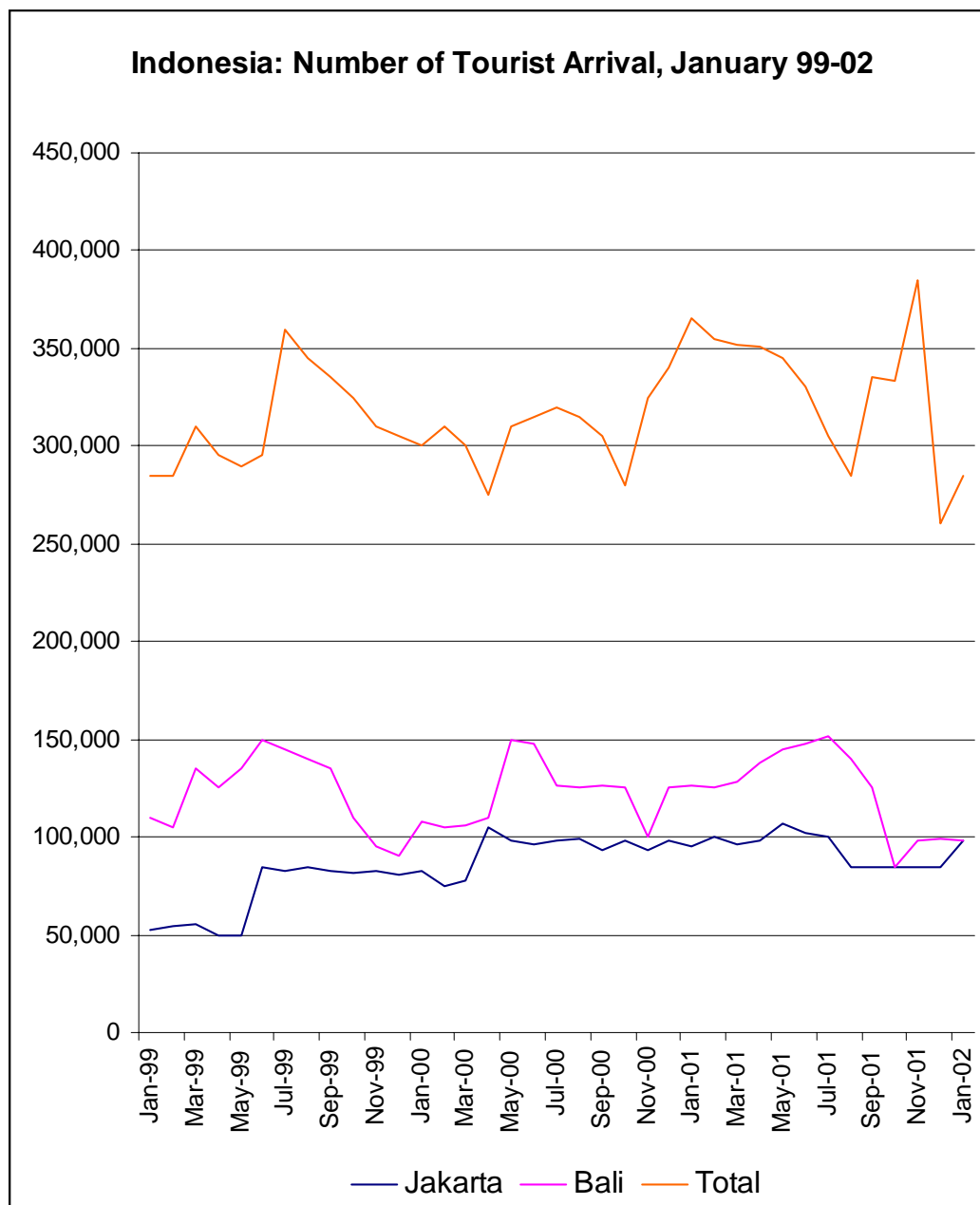


Commodity market channel evidence



- ◆ *It seems that the 9/11 attack affected the domestic economy mostly through the commodity market channel both from a decline in demand and a reduction in price. Those impacts were not fully restored until recently.*

Tourism flows after the 9/11 attack.



- ◆ During the last quarter of 2001, the number of tourist arrivals dropped by 30,000 tourists compared to the same period of 2000. This means, if the average tourist spends about \$95/day and stays 3 days, the tourist industries lost about US\$10 million in that quarter.

Overall estimates on the domestic economy

- ❖ It is small relative to total GDP or the crisis of 97-98 but definitely not trivial. Using a simple elasticity approach, we find overall it costs about .4 percentage point of GDP. But it is included the global recession effect which was already started since the 1st quarter 01. This

was in 2001 with effects diminishing in 2002 so long as there are no repeats of significant terrorism.

❖ **The cost of terrorism in Indonesia (so far) turns out to be small because of several reasons:**

- ◆ It is one time event but if we have repeated events the impacts eventually become significant and escalating especially if the global community fail to respond and handle it effectively.
- ◆ The 911 attack has produced a better coordination among G-7 countries
- ◆ The outcomes from Afghanistan crisis have been surprising the market and resulted a quick turnaround in market recovery
- ◆ Indonesia is not the main target of terrorism such that we are not incurred a direct cost terrorism.

Possible solutions for reducing terrorism?

❖ **Find the underlying causes of terrorism**

- ◆ Does poverty increase the probability to terror attack as suggested by many influential people?
 - A recent study by Alan Kruger (Princeton University) and Jitka Maleckova (Charles University) suggests that neither poverty nor education have a direct, causal impact on terrorism but they may contribute indirectly.
- ◆ It seems that political factors play more important role rather than the economic ones. In the sense that many non democratic system do not do a good job of responding to the needs of aspirations of their people, particularly young people and this provides fertile grounds for recruiting terrorists



CONFERENCE

on

THE ECONOMIC COST OF TERRORISM: INDONESIA'S RESPONSES

Tuesday, 7 May 2002
Shangri-La Hotel, Jakarta

Indonesia's External Trade
And Competitiveness:
Assessing the Economic Costs of Terror

William E. James

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CENTRE FOR STRATEGIC AND INTERNATIONAL STUDIES
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Indonesia's External Trade and Competitiveness: Assessing the Economic Costs of Terror

William E. James*

I. Introduction.

There is little doubt that the events of September 11, 2001 and apprehensions regarding the security situation in Indonesia in the wake of the terrorist attacks and the launching of allied military operations in Afghanistan have had a negative impact on Indonesia's trade and competitive position. The quantitative analysis of the economic costs of terrorism is a complex task that goes well beyond the scope of this paper. The fact that recessions had already begun in both of Indonesia's major export markets before the attacks took place makes it extremely difficult to infer the extent to which each of these events is to blame for the subsequent downturn in exports (and imports). The volatility of exchange rates and world prices of commodities that Indonesia exports further muddy the water. Hence, rather than attempting to quantify or isolate the impact of the particular events that have occurred, an attempt is made to qualitatively assess how the terrorist attacks and related events may have influenced the external trade and competitiveness of Indonesia using the most recent available data.

The deterioration of the external economic situation facing Indonesia in the year 2001 compared with 2000 was apparent even prior to the 9-11 attacks. The United States' decision to strike back at the culprits and to launch a more general

* This paper has been prepared for the joint USAID-CSIS Seminar on "The Economic Cost of Terrorism: Indonesia's Responses," May 7-8, 2002, Shangri-La Hotel, Jakarta. The author is Senior International Economist, Nathan Associates, Inc. in the Partnership for Economic Growth (PEG) Project. Presently the author is serving as PEG advisor to Bank Indonesia, Jakarta, Indonesia. PEG is a USAID-funded project in cooperation with the Indonesian government. The figures reported herein are preliminary and subject to revision. These data, compiled by the author from a variety of sources, where possible are in common units using the IMF period average exchange rate. The views expressed herein are those of the author and not necessarily those of USAID or the Indonesian government.

global campaign against terrorism put Indonesia in a delicate position. Indonesia was presented with a clear political choice in responding to these events in an already difficult economic environment. The choice to actively join or not to join in the fight against terrorism carried weighty economic consequences for Indonesia. The decision to respond positively, if tentatively at first, to the call to combat global terrorism was welcomed by the United States and, generally, by the international community. Economics clearly played an important role in Indonesia's decision, but this is not to suggest that only economics was the driving factor.

The economic consequences of a failure to respond as Indonesia did would have been quite serious. By choosing as it did, the government of Indonesia has subsequently been able to successfully negotiate debt rescheduling under the generous terms of the Paris Club III with positive implications for the fiscal budget. The improving fiscal situation, brought about by reduced subsidies on fuel, electricity, basic telephone services and public transportation, coupled with successful asset sales (Bank Central Asia in particular) has helped to reduce upward pressure on interest rates and reverse downward pressures on the exchange rate. In turn, stock prices have rebounded and, although year-on-year inflation is still running high through April (13.3% year-on-year), the rate of inflation rate has finally eased after accelerating in the first two months of 2002. Whether or not one thinks the inflation target of 9-10 per cent for CY2002 is obtainable, base money growth has decelerated and is well below the indicative target. The macroeconomic economic situation has begun to turn for the better. This improvement would have been almost inconceivable if Indonesia had made the choice not to participate in the global campaign against terror.

Indeed, if Indonesia had chosen to turn its back on the global alliance to combat terrorism, it is very conceivable that the macro situation would have

worsened. And it remains conceivable that unless Indonesia takes the path of strengthening its commitment to the global effort to eradicate terrorism, there could be negative near term impacts on exports, investment, tourism, the exchange rate, prices and the budget.¹

In this paper, section II examines the impact of the world economic downturn, particularly the recessions in the US and Japan, on Indonesian trade in a comparative perspective. Section III addresses the US economy's recovery prospects and the prospects for recovery of world economic activity in 2002 and the implications for Indonesia. Section IV identifies new challenges facing Indonesia and the implications of Indonesia's stance on the fight against terror in withstanding these challenges and Section V concludes with some policy implications for Indonesia.

II. The Global Slowdown, September 11 and Export Performance in 2001.

Major markets for Indonesian products experienced deteriorating growth as the year 2001 progressed. The entry of the US, Japan and European countries such as Germany into a synchronized recession had sharply reduced global demand for Indonesian exports. Japan, the number one market for overall exports and the second largest market for non-oil exports, reported first quarter growth of just 0.2 per cent, revised second quarter growth is -0.7 per cent, with third quarter growth estimated to be -0.5 per cent. In the fourth quarter, GDP fell again so that growth for the year 2001 was -0.5 per cent.² Japan's third recession in a decade is the most serious as GDP had

¹ The question of how events will influence world oil prices is of obvious importance in determining the outcome for Indonesia as a net oil exporter. However, the focus of this paper will be on the non-oil economy, leaving the oil price issue to other analysts at the seminar.

² Note that economic growth rates are calculated based on gross domestic product in constant local currency prices whereas trade growth rates are calculated on the basis of exports and imports of goods in current US dollar prices. Hence, one cannot infer income elasticity of demand from these data.

never before contracted for three consecutive quarters since Japan revised its method of calculating GDP in 1980.

In the United States GDP growth fell to 0.3 per cent in the second quarter (revised upward from 0.2 per cent) from 1.3 per cent in the first quarter, and growth in the third quarter became negative (-1.3 per cent), the weakest performance in ten years.³ The impact of the recessions on the non-oil export data from the Central Statistical Agency of Indonesia in the table below is clear:

Table 1

| Indonesia: Non-Oil Exports to Japan and USA | | | | | |
|---|--------------|---------|---------|---------|---------|
| | (mil. US \$) | | | | |
| | Q1 | Q2 | Q3 | Q4 | Q1-Q4 |
| Japan | 1,917.1 | 1,736.3 | 1,617.3 | 1,352.8 | 6,623.5 |
| % Change* | 13.42 | -4.95 | -13.51 | -32.8 | -10.48 |
| USA | 1,880.0 | 1,972.3 | 1,929.1 | 1,444.7 | 7,226.1 |
| % Change* | 7.31 | -5.45 | -14.97 | -9.2 | -8.10 |
| *Year-on-year growth comparing the period in 2001 with the same period in 2000. These data are all in current prices. | | | | | |
| Source: BPS, Buletin Ringkas and Berita Resmi Statistik, various issues. | | | | | |

As income growth has become negative in Japan and the US, and stagnates in the EU, the outlook is bleak across Indonesia's main export destinations. The downturn in the economies of the US and Japan had a severe impact on non-oil/gas exports in 2001 in both key markets. In order to obtain a complete and accurate picture of the downturn's impact, comparison of import data from the two main Indonesian markets with data in Table 1 above is instructive.⁴

³ The National Bureau for Economic Research (NBER), announced that the US economy entered recession in March 2001, based upon somewhat different criteria than the standard two quarters of zero or negative growth. The NBER assessment is based upon rising unemployment, declining industrial production, personal income and wholesale and retail trade.

⁴ For a variety of reasons, import data from partner economies may differ from the export data of the

The growth of non-oil/gas imports from Indonesia in the US and Japan sharply deteriorates as the year 2001 progresses mirroring the Indonesian export data although the magnitude of decline is smaller using the import data. Growth rates, calculated for each quarter of 2001 and for the year based on official import data from US and Japanese sources, provide a clear picture of the impact of the recessions (table 2). Weakness in consumer demand in the US and Japanese economies began to take its toll in the second quarter of 2001. U.S. import statistics present a picture that is broadly consistent with the Indonesian export data.⁵ Growth in demand for Indonesian products has taken a turn for the worse: 11 per cent growth in the first quarter, -1.0 per cent growth in the second quarter, -7.8 per cent growth in the third quarter and -10.8 per cent growth in the fourth quarter.⁶ Import data from Japan (converted into US dollars) reveal a similar picture: 10.4 per cent growth in the first quarter, -0.5 per cent in the second quarter, -3.8 per cent in the third quarter and -21.1 per cent in the fourth quarter. The third and fourth quarter declines in imports from the rest of ASEAN in the US and Japan was sharper than Indonesia. However, imports from China held up much better in the final two quarters in both the US and Japan.

It is important to note that the composition of imports from Indonesia in the US and Japan differ considerably.

source country. For Indonesia, one of the most important differences arises from the use of Singapore (and to a much lesser extent, Hong Kong) as a transshipment center. Indonesian statistics do not distinguish between exports retained by Singapore and re-exports and Singapore does not publish its trade statistics with Indonesia.

⁵ As Indonesian export data become available in detail, the author will check their consistency with US import data.

⁶ Data compiled by PEG consultant Peter Minor from US sources.

Table 2

| Growth Rates of US and Japanese Imports from Indonesia | | | | | |
|---|-------|-------|-------|-------|-------------|
| (2001 vs. 2000, quarterly and annual growth in per cent) | | | | | |
| | Q1-Q1 | Q2-Q2 | Q3-Q3 | Q4-Q4 | Annual 2001 |
| US | 11.0 | -1.0 | -7.8 | -10.8 | -2.7 |
| Japan | 10.4 | -0.5 | -3.3 | -21.1 | -4.4 |
| Growth Rates of US and Japanese Imports from China | | | | | |
| (2001 vs. 2000, quarterly and annual growth in per cent) | | | | | |
| | Q1-Q1 | Q2-Q2 | Q3-Q3 | Q4-Q4 | Annual 2001 |
| US | 12.8 | 2.1 | -1.3 | 0.3 | 2.7 |
| Japan | 15.8 | 7.5 | 1.8 | -6.8 | 3.8 |
| Growth Rates of US and Japanese Imports from ASEAN (ex. Indonesia) | | | | | |
| (2001 vs. 2000, quarterly and annual growth in per cent) | | | | | |
| | Q1-Q1 | Q2-Q2 | Q3-Q3 | Q4-Q4 | Annual 2001 |
| US | 1.3 | -12.1 | -24.3 | -19.7 | -14.6 |
| Japan | 7.3 | -4.9 | -16.5 | -26.2 | -10.8 |
| Source: <i>US Department of Commerce Imports of Merchandise Trade CD-ROM</i> ; | | | | | |
| <i>Japan, Ministry of Finance homepage: http://www.mof.go.jp/english/1c015fle.htm</i> | | | | | |

In Japan, a much higher proportion of imports (nearly 60 per cent) are primary products and processed resource-based industrial goods. In 2000, base metal and ores, wood and wood products and fishery products alone accounted for 50 per cent of Japan's imports from Indonesia.⁷ In contrast, in the United States, primary products

⁷ These figures are derived from official sources. See William E. James, "The Competitiveness of Indonesian Non-Oil Products in Major Markets: Market Shares in the United States and Japan," Partnership for Economic Growth, Jakarta, March 2002.

and those of resource-based industries comprised less than 20 per cent of imports from Indonesia in 2000.

Manufactured products, chiefly in labor-intensive industries, accounted for the lions' share of imports. Textiles & apparel (24%) and footwear (7%) were among the largest US imports from Indonesia in 2000. The implication of this difference is that Indonesia faces much greater competition from a broader range of producers for its products in the US market than it does in Japan. Any developing country with abundant labor may compete with Indonesia in the US market in labor-intensive manufactured products, however, only a few countries possess similar stocks of diverse natural resource wealth as Indonesia and so there are fewer competitors facing Indonesian products exported to Japan.

The unprecedented events of September 11 in the United States have had a strong negative impact on demand for Indonesian products. Buyers have reportedly been unwilling to travel to Indonesia and have begun to source purchases elsewhere in the region. In part, this is a result of the perception that foreigners, particularly Americans, may be targets of extremists and the issuance of threats against American interests has reinforced this negative image of Indonesia. Indirect evidence of the negative impact of the September 11 attacks is seen in the fact that growth rates of US imports of nine of the ten top labor-intensive product groups from Indonesia were negative in the fourth quarter of 2001. In seven of nine cases, growth became negative, or if already negative, worsened in the fourth quarter compared with the third quarter of the year. These products include apparel items (5 SITC 3-digit product groups), footwear, and toys and sporting goods.⁸ The downside of the

⁸ James, *ibid.*

terrorist attacks of September 11 are likely to be magnified should Indonesia be unable to respond effectively to reverse these negative perceptions in the US.

Germany technically entered a recession, with contractions in the second through the fourth quarter. Growth for the year 2001 as a whole was a paltry 0.5 per cent. In other countries of Europe such as the UK, growth has also begun to slow. Growth in Italy and France became negative in the fourth quarter of the year compared with the previous quarter. Overall, growth in countries in the Euro Zone was estimated to be 1.5 per cent in 2001.⁹

Hong Kong, Taiwan and Singapore recorded negative real economic growth in 2001. Taiwan's recession is the deepest it has ever experienced, with three consecutive quarters of negative year-on-year growth beginning with the second quarter of 2001. Hong Kong had negative growth year-on-year in both the third and fourth quarters of 2001. In Singapore, GDP contracted by 2.2 per cent in 2001. Korea managed to record 2.8 per cent positive GDP growth for 2001, but the outlook for 2002 remains clouded with uncertainty.

Revised global economic growth forecasts reflect the expectation of a prolonged recession. For example, the IMF forecast was revised downward in October 2001 from that of May and indicated that world income will grow by less than 3.0 per cent in 2001 and by only 2.4 per cent in 2002.¹⁰ Slower growth in world income would result in further weakening of demand for Indonesian exports with potentially serious impacts on economic growth in 2002. The forecast for growth of real GDP in developing countries is 4.4 per cent in 2002, led by Asia with a respectable 5.6 per cent growth (led by China and India).

⁹ Data for the 15 member countries of the EU trade with Indonesia have not been compiled as of the time of writing of this paper.

¹⁰ The revised IMF projection of US growth in 2002 is 0.7 per cent, indicating that the recession was expected to continue into the first two quarters of 2002.

Overall, Indonesian exports (including oil and gas) growth in the year 2001 fell by 9.8 per cent compared with the year 2000 (US\$56.04 billion vs. US\$62.12 billion).¹¹ Non-oil/gas exports declined by 9.1 per cent during 2001 compared with 2000 (US\$43.41 billion vs. US\$47.76 billion). The growth in oil and gas exports was -12.09 per cent 2001. Both agricultural (-9.3 per cent) and manufacturing (-11.1 per cent) exports have declined while mining exports have risen sharply (18.7 per cent) during the year. Indonesia's export performance has held up better than a number of other East and Southeast Asian economies (see the Table 3 below). One reason for this is that Indonesia is less dependent on electronics for exports than many of the neighboring countries. For example, in Taiwan, electrical machinery and equipment made up 56 per cent of merchandise exports in 2000 and exports in this sector alone declined by almost 20 per cent in 2001. There is also heavy dependence on electrical machinery and equipment in Singapore, Malaysia, the Philippines, and Korea where export growth contracted sharply during the year.

National statistical agency's reports around the region reflect the deepening economic slowdown. For example, a comparison of the January-December period compared with the earlier months of the year finds that in all cases export growth fell in the nine economies reported upon in the table 3 below.¹²

In Hong Kong, growth of domestic exports was -11 per cent over the calendar year of 2001 compared with 2000. Overall export growth was helped by the fact that re-exports (mainly of goods from Mainland China) held up better than domestic

¹¹ Exports are on an FOB basis, while imports are on a CIF basis unless otherwise noted.

¹² Two previous reports for growth during the first seven months of 2001 and the first nine months of the year may be requested from the author: "Indonesia's Export Performance and the Global Economic Slowdown: A Comparison with other East and Southeast Asian Economies," September 14, 2001 and "Indonesia's Export Performance and the Global Economic Slowdown: An Update for the Period January-September 2001," November 14, 2001.

exports. Despite the relatively mild contraction of re-exports over the year (-1.5 per cent), the decline became pronounced starting in September at -9.5 per cent.

Table 3

| Comparison of Indonesian Export Performance with Asian Economies | | |
|--|--|----------------|
| Country/Territory | Export Growth 2001 (year on year, % change) | Period |
| Hong Kong | -2.6 (-11.0*) | Jan.-Dec. 2001 |
| China, Mainland | 6.3 | Jan.-Dec. 2001 |
| Indonesia | -9.8 | Jan.-Dec. 2001 |
| Korea | -13.0 | Jan.-Dec. 2001 |
| Malaysia | -10.0 | Jan.-Dec. 2001 |
| Philippines | -15.6 | Jan.-Dec. 2001 |
| Singapore | -11.8 (-16.2*) | Jan.-Dec. 2001 |
| Thailand | -6.4 | Jan.-Dec. 2001 |
| Taiwan | -17.1 | Jan.-Dec. 2001 |
| *Domestic exports (excluding petroleum in the case of Singapore). Sources: Author's compilations from national statistical agency home pages for Taiwan, Singapore and the Philippines, from national trade ministries for Korea, Malaysia, Thailand and Hong Kong and from the US-China Business Council for Mainland China. For Indonesia data are from the Central Statistical Agency home page, <i>Berita Resmi Statistik</i> , January 1, 2002 and Ministry of Industry and Trade. | | |

In the region, China stands out as the only country that has sustained positive export growth in 2001, although indications (such as the decline in re-exports in Hong Kong noted above) are that growth there slowed significantly as the year progressed. For example, China's export growth slowed from almost 15 per cent in the first quarter to 8.8 per cent for January-June and 6.1 per cent for January-September.

However, surprisingly, growth for January-December was 6.3 per cent, indicating fourth quarter performance was relatively good.

In markets in the region, with the exception of the Republic of Korea, there has been a decline in demand for Indonesia's non-oil exports in 2001. Although some Asian countries are moving to fiscal stimulus, including Taiwan, Malaysia, Singapore and Thailand, this may not be enough to lift demand for imports in these markets until the second half of 2002.

Table 4

| <i>Comparison of Import Growth in Asian Economies</i> | | |
|--|--|----------------|
| <i>Country/Territory</i> | <i>Import Growth 2001</i> (year on year, %) | <i>Period</i> |
| Hong Kong | -5.4 | Jan.-Dec. 2001 |
| China, Mainland | 8.6 | Jan.-Nov. 2001 |
| Indonesia | -8.1 | Jan.-Dec. 2001 |
| Korea | -12.0 | Jan.-Dec. 2001 |
| Malaysia | -9.9 | Jan.-Dec. 2001 |
| Philippines | -5.9 | Jan.-Dec. 2001 |
| Singapore | -14.4* | Jan.-Dec. 2001 |
| Thailand | -0.6 | Jan.-Dec. 2001 |
| Taiwan | -23.4 | Jan.-Dec. 2001 |
| *Non-oil imports. | | |
| Sources: author's compilations from national statistical agencies' home pages. | | |

China's positive export growth performance matched positive import growth during the year (see Table 4 above). However, Indonesian non-oil/gas exports to China recorded -9.4 per cent growth in 2001 (year-on-year).¹³

Imports in the East Asian region have started to follow exports with the downturn (Table 4). Growth of imports started to deteriorate sharply in the second quarter of 2001 and this trend appears to be worsening with the latest reports in the third and fourth quarters showing double-digit negative import growth across much of East Asia. For example, import growth for the month of September 2001 (compared with the same period in 2000) was -34.1 per cent in Taiwan and -12 per cent in Korea. In October, negative growth in imports of -21 per cent in Taiwan and -18 per cent in Korea reflect weakening demand as well. In November 2001, import growth was -19 per cent in Korea and -34 per cent in Taiwan. Finally, in December imports growth (year on year) was -14 per cent in Korea and -18 per cent in Taiwan.

Additional analysis of Indonesia's export performance may shed some light on the vulnerability of non-oil/gas exports to the global slowdown. With the deteriorating external environment, one expects that the decline in export growth may accelerate. Indonesia's export performance clearly deteriorated over the course of the year as income growth has declined in major markets. Second quarter growth of total exports dropped to -5.1 per cent compared with positive 5.1 per cent growth in the first quarter as external demand continued to weaken. For non-oil/gas exports the growth also became negative in the second quarter (-7.4 per cent) after posting positive 3.6 per cent growth in the first quarter. In the third quarter non-oil/gas exports grew (year-on-year) by -12.6 per cent and in the final quarter by -18.9 per

¹³ BPS reports a fall in non-oil/gas exports to Singapore in the first nine months of 2001 with a drop in value of over 17 per cent. As Singapore does not publish data on trade with Indonesia, it is not possible to sort out the actual amounts that have Singapore as the ultimate destination of goods exported from Indonesia.

cent. Underlying the declining growth performance is weakness in prices of the products Indonesia exports rather than falling volumes, though there is substantial variance between industries and commodity groups. The diversity of Indonesian exports (including some that are relatively demand inelastic) helped sustain overall performance. Certainly, the lower reliance on electronics as an export in Indonesia relative to neighboring countries has shielded it from a more severe downturn. Consumers in markets for basic commodities may substitute away from expensive brands and items to less expensive ones as their expected real income falls and this may create some opportunities for Indonesian producers to increase their market share.

Indeed a new study of market share of the top 50 Indonesian products in the two major markets of Japan and the United States for the year 2001 indicates this may be the case. In the US, despite contraction in imports in 28 of the 50 product groups, Indonesia increased its share of US imports in 24 cases, had no change in 8 product groups and lost market share in 18. In Japan, there was also a decline in import demand in 28 of the 50 product groups. Indonesia gained market share in 30 product groups, had no change in 4 and lost market share in 16 product groups. Although these data are partially reassuring, there are signs that competitive pressures are mounting on key Indonesian industries, including footwear, apparel, textiles, and wood products. Among the top competitors are China and countries with which the US has entered into free trade agreements, particularly Mexico and Canada.¹⁴

As was the case with exports, Indonesia's growth in imports is slowing as the year progressed and was much lower in the second quarter compared with the first three months of the year. In part, import growth in the first half of the year reflected

¹⁴ William E. James, "The Competitiveness of Indonesian Non-Oil Products in Major Markets: Market Shares in the United States and Japan," March 11, 2002, Jakarta: Partnership for Economic Growth.

the recovery and pent-up demand resulting from the crisis in previous years. One can see the drop off in import growth rates from strong growth in the first two quarters to sharply negative growth by the third quarter. In the fourth quarter imports have contracted by over 40 per cent compared with the same period in the previous year.

Table 5

| Indonesia: Export and Import Performance in 2001: Quarterly Data in Current Prices | | | | | | | | |
|--|--------------|-------|-------|-------|------------|------|-------|-------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 | Q4 |
| | (US\$, bil.) | | | | (% Change) | | | |
| Total Exports | 14.87 | 14.43 | 14.37 | 12.29 | 5.1 | -5.1 | -14.2 | -23.3 |
| Non-Oil/Gas | 11.18 | 11.15 | 11.30 | 9.72 | 3.6 | -7.4 | -12.6 | -18.9 |
| Oil & Gas | 3.75 | 3.29 | 3.07 | 2.58 | 10.0 | 3.4 | -19.2 | -36.0 |
| Total Imports | 9.21 | 8.54 | 7.00 | 6.04 | 40.5 | 17.8 | -25.3 | -41.9 |
| Non-Oil/Gas | 8.02 | 7.20 | 5.29 | 4.92 | 51.6 | 23.9 | -29.6 | -44.5 |
| Oil & Gas | 1.20 | 1.33 | 1.71 | 1.52 | -5.7 | -3.5 | -8.1 | -0.7 |
| Growth rates are calculated as year-on-year changes, i.e., Jan-Mar of 2001 compared with Jan-Mar 2000. | | | | | | | | |
| Source: Ministry of Industry and Trade and Central Statistical Agency. | | | | | | | | |

III. Prospects for Recovery in the United States: A “Mini” Recession?

Growth in the October-December quarter of 2001, initially estimated to be 0.2 per cent, actually was a surprising 1.4 per cent. There are other signs that the US economy is entering into a recovery phase, including continued high productivity growth (3.5 per cent in the fourth quarter and around 1.7 per cent for the year). Inflation remains muted and the US dollar has strengthened against the Euro and the

Yen. Aside from some risk of a “double-dip” recession, however, evidence of a recovery is mounting.

Interest rate cuts and tax reductions in the US helped to stimulate consumer demand and to cushion the pressure of firms and industries as they reduced inventories and cut back production. US consumer confidence, already down because of the stock market correction and rising unemployment, was severely shaken by the September 11 attacks. However, confidence appears to have begun to recover according to surveys of consumers conducted by the University of Michigan. The latest survey for March reports a higher than expected index of confidence and reflects the 5th increase in the past six months. Consumer spending has held up with purchases of autos and housing rising. Another reason for consumer resilience in the US market is that inflation has been falling steadily from an annualised rate of 3.2 per cent in June of 2001 to just 1.1 per cent in January of 2002. This has helped sustain real incomes despite the job losses and adverse wealth effects of the stock market declines.

IV. Outlook for 2002

For the year 2002, a number of countries in the region had projected negative growth of exports and imports during the first two quarters, but expected second half growth to rise sharply. This pattern based, in part, upon the expected pattern of recovery in the United States, may be unduly pessimistic. Most of the negative growth in current dollar amounts has been due to falling commodity prices, export volumes have actually been increasing. The expectation of a continuation of the US recession into the first and second quarter of the year appears to have been mistaken. Federal Reserve officials and others, including Fed Chairman Alan Greenspan have acknowledged that the economy is already entering the recovery phase. Recent data

confirm that industrial output rose by 0.2 per cent in January 2002 and by 0.4 per cent in February (compared with the previous month). Industrial output still remained over 4 per cent below last year's level in 2002 in the first two months, but the month-on-month increases indicate recovery is at hand.

The first quarter of 2002 GDP numbers were very good at 5.8 per cent year on year growth. The surge in production was caused in large part by inventory investment as firms began to restock after running down inventory levels during 2001. This recovery may not be as robust as previous recoveries, with growth at about 3 per cent only in the second half of 2002. Typically, recoveries usually achieve around 5 or 6 per cent growth during the first year, but it is unlikely that the first quarter performance will be sustained unless private capital formation accelerates rapidly for the rest of the year.

Prospects for Indonesian exports in the New Year improve with the early recovery in the US, but diminish with the expectation that the recovery will be sluggish after the first quarter. The likelihood that Japan will not soon escape from its economic difficulty, and more intensive competition from producers seeking to aggressively increase exports and penetrate markets also cloud prospects for Indonesia.

There are some possible signs of "bottoming out" as domestic exports of Singapore (-4.1 per cent in January of 2002) declined by less than expected and was less than the -16.7 per cent recorded in December of 2001. Similarly, in Korea the January 2002 contraction in exports (-8.9 per cent) was less than expected and lower than the actual decline of -19.6 per cent in December of 2001. This was also the case for Taiwan where exports (-1.4 per cent) also fell less than expected and less than in the previous month. However, fourth quarter trade figures are not reassuring and

indicate a continuation in the downward trend. For example, export growth in Korea was -20 per cent in December of 2001 and import growth was -14 per cent. And while January export data came in better than expected for Korea, exports for the month of February 2002 performed poorly, indicating that it is advisable to await first quarter numbers before reaching any conclusions.¹⁵

China's export growth accelerated in January-February 2002, up by 14.1 per cent year-on-year. In the case of the US market, China's exports rose by 18 per cent during this period. Hence, it is likely that China will continue to set the pace in Asia in terms of export performance in the coming year, particularly given the improved market access it is starting to enjoy as a WTO member.

The outlook is further complicated by three factors: 1) the sharp depreciation of the yen against the US dollar; 2) the entry of China into the WTO; and 3) the initiation of discriminatory preferential free trade agreements by many of Indonesia's most important trading partners.

Assessing the impact of each of these three factors is rather complex. For example, the yen's decline results in reduced import demand in Japan but also lowers the cost of imported Japanese components used in Indonesian export industries.

In the case of China's WTO entry, there are also complexities in the sense that China will open its markets for agricultural commodities and manufactures of interest to Indonesia but will also enjoy better terms of market access in key sectors in both the United States and the EU. For example, in textiles and apparel China's export growth was constrained in volume to 1 per cent quota growth in the US market until January 1, 2002. From now on, however, China will receive full benefits from the

¹⁵ The first two months of the year provide an unsatisfactory basis for making any firm statements about export recovery because of strong seasonal factors, particularly the shortened number of workdays due to New Year holidays in these months.

quota liberalization in the US and EU under the Uruguay Agreement on Textiles and Textile Products.

In assessing the impact of new free trade agreements one must distinguish trade creation effects from those of trade diversion--an inherently difficult task *ex ante*. The best way to assure the minimization of trade diversion is to push forward multilateral negotiations for overall trade liberalization in the WTO Doha Round.

In addition to the uncertainties in the international economy, Indonesia faces many domestic problems and challenges that may influence its ability to produce and compete in the international market place. One problem in this regard is that Indonesia is an outlier in terms of domestic price inflation and this will undermine Indonesian products competitiveness, all other things equal, in foreign markets.

Inflation appears to be closely associated with growth in base money and also with depreciation of the currency. Administered prices of items such as fuel, electricity, public transportation, and volatility in food prices add to inflationary pressures. However, studies by Bank Indonesia and by the IMF show that even after stripping away these volatile elements, so-called "core inflation" remained in double digits in 2001 and in the first quarter of 2002.

Table 6

| Consumer Price Inflation in East Asian Economies | | |
|---|--------------------------|----------------------|
| | (% change, Year-on-Year) | |
| Country/Region | 2000 | 2001 |
| Hong Kong | -3.8 | -1.6 |
| China | 0.4 | 1.1 (Jan.-Jun. 2001) |
| Korea | 2.3 | 4.1 |
| Indonesia | 9.4 | 12.6 |
| Malaysia | 1.6 | 1.4 |
| Philippines | 4.4 | 6.0 |
| Thailand | 1.6 | 1.6 |
| Taiwan | 1.3 | 0.0 |

Source: Compiled by the author using national statistical agencies' publications and home pages.

V. Conclusion.

Trade data for the first quarter of 2002 show a mixed picture in the region. For example, in Hong Kong exports recorded 2.2 per cent growth in March 2002, marking the first increase in 13 months. In Korea, first quarter growth of exports was negative, though March exports declined by far less (-5.7%) than in the first two months (-12.9%) and recorded growth of 9.3% in April. In Thailand and Vietnam, export growth was also negative in the first quarter. However, the negative growth reflects declining world prices of commodities rather than declining volumes of exports.

Indonesian export data from the Central Statistical Agency for the first quarter of 2002 indicate negative growth (year on year) for total exports (-13.9%) and for non-oil exports (-9.6%). However, growth in non-oil exports in the first quarter of 2002 compared with the fourth quarter of 2001 reached 3.4% and for total exports was 1.3%, indicating a turnaround is likely. Data on imports, however, are cause for concern if the numbers are correct.¹⁶ Import data for the first quarter of 2002 indicate year on year growth of -30.7% (total) and for non-oil products of -36.8%. These numbers are hardly consistent with an economy growing at a real rate of over 3%! However, quarter on quarter growth of non-oil imports is 5.2% and for total imports is 5.8% (comparing the first quarter of 2002 with the final quarter of 2001). Import data for capital goods for the first quarter of 2002 compared with the same period in 2001 indicate growth of -37.5%. These figures do not provide much optimistic news about capital formation.

Inflation data (CPI) for April (-0.24% compared with the previous month) and 13.3% year on year for the first four months of 2002 compared with the same period in 2001. Inflation is decelerating, reflecting slower growth in base money since the second half of 2001, and the recent appreciation against the US dollar will also help moderate inflationary pressure. On the other hand, increases in fuel prices will add somewhat to headline inflation measures during the course of the year. The positive effects of reducing fuel subsidies on the budget over the course of the year will have enormous benefits in keeping the deficit within bounds.

Progress in asset disposal, along with the Paris Club III rescheduling, will also reduce budgetary pressures. The combination of a stronger currency, reduced budget

¹⁶ The existing of rampant smuggling, under-invoicing and false classification of imports may lead to gross understatement of the level of imports. Reconciliation of Indonesian import figures with export figures of partners is difficult, as Singapore, the third largest trading partner, does not publish statistics on trade with Indonesia.

deficit and moderating CPI inflation indicate that macroeconomic conditions are improving. Thus, cautious optimism is warranted, provided the government can continue to make progress in legal reform and in institutional reform (such as in cleaning up the Customs and Tax Departments).

On the trade front, Indonesia will face the challenge of coping with the great changes that are taking place in the global trading system. For Indonesia, the most immediate challenge comes from China's entry into the WTO. Particularly, in textiles and textile products (Indonesia's most important export industry in terms of employment, non-oil exports and manufacturing production), the China challenge appears to be huge. Data from the US, where China is no longer constrained to 1 per cent quota growth per annum, indicate huge leaps in China's market share relative to other competitors, including Indonesia. The reasons underlying the shifts in market share in textiles and textile products (apparel) in the US, Japan and Europe should be carefully analysed in order to rectify any shortcomings in present policies.

All in all, Indonesia can ill-afford the adverse impact that association with extremism and terror will have on its image and on the perception of potential buyers and investors. Hence, attention to measures to combat extremism and terrorist groups coupled with strenuous reforms will be essential for strengthening the ability of Indonesian producers to compete in the international markets.



CONFERENCE

on

THE ECONOMIC COST OF TERRORISM: INDONESIA'S RESPONSES

Tuesday, 7 May 2002
Shangri-La Hotel, Jakarta

Perceptions of Indonesia's Investment Risk

JAMES VAN ZORGE

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Perceptions of Indonesia's Investment Risk

Beginnings: The Myth of Sound Fundamentals

I remember back in the late 1980s, when I first arrived in Indonesia, I was struck by the rising optimism that pervaded the international investment community. This optimism was focused not only on Indonesia, but also the entire Asia-Pacific. The emerging tigers of South East Asia became the darlings of direct foreign investors—first coming from Europe and, later, starting in the early 1990s, the American multinationals. What started as a trickle eventually became a boom, and it seemed that talk of an Asian miracle was destined to become a reality.

Later, in the mid-1990s, boardrooms across the globe talked incessantly of the three large emerging markets: China, India, and Indonesia. Multinationals started to think about these countries not just as export platforms for low value-added manufactured goods and natural resource exploitation, but as exciting growth opportunities for selling luxury and fast-moving consumer goods to their increasingly wealthy domestic populations.

Working with the Harvard Group as an economics advisor to the Indonesian government during the early years of the investment boom, it was clear to me that the Soeharto government and its Western-educated economics czars were truly committed towards a liberal, open-economy policy regime. The results were, as we know, quite impressive: as numerous monopolies and cartels were dismantled, and literally thousands of tariffs were slashed, the non-oil and gas industries surged. Not only did the Soeharto cronies stand to benefit, but also a fast-growing middle class began to emerge.

It was around this time, in the early- to mid-1990s, that the macromantra of 'sound fundamentals' began to gain popular coinage amongst the foreign investment community. The international banking community seemed insatiable in its lending to corporate Indonesia. It was only a few years before that foreign banks only had an appetite for sovereign risk. Now they were willing to take on direct lending to Indonesian conglomerates: Instilled with tales of hot management talents and promises of continued high growth, portfolios bulged.

The rest of the story, as we know it, belongs to the historical dustbins of pure folly. The Thai baht collapsed, and Soeharto followed. Memories of 'sound fundamentals' quickly faded into the distant background, if not an embarrassment to those who subscribed to the notion that Indonesia served as a 'must' for serious investors.

I won't dwell here on what actually went wrong with Indonesia. There are numerous accounts of the Asian economic crisis, Indonesia included, and why we believe it actually happened. Rather, I am more interested in exploring how direct investors behave, and what causes them to risk their money in one place as opposed to another. And here I think Indonesia is an excellent case study: Going from what was thought

to be an economy governed by sound fundamentals and low risk, towards a sick economy with a bleak short-to medium-term outlook, and relatively high risk.

In thinking back towards when I first arrived in Indonesia almost 15 years ago, I am awed by the fact that investors were convinced for such a long time with the mythical tale of sound fundamentals and then, suddenly, have all now bought into the notion that Indonesia is on the verge of becoming an economic basketcase, if not already. Does this make sense? What do such perceptions have to do with reality, and could such perceptions suddenly change in the future, as well? If so, then the implications for Indonesia could be very interesting, indeed.

Ground Floors and Coffee Shops

Several months ago, I had a coffee in one of my favourite hangouts: Dome Café, which happens to be located on the ground floor of Sogo Indonesia, and directly across the Hotel Indonesia traffic circle. I was first attracted to Dome because it was an ideal vantage point to watch the daily demonstrations that took place at the traffic circle: admittedly, I found demonstrators' banners quite amusing, especially those that read "Hang Soeharto", and found them as a perfect antidote to the occasionally bad lunch.

Lately, demonstrations have become less frequent, and so when bored I find myself with nothing else to do but peer out the front window of Dome and watch the traffic. Compared to the Wahid and Habibie eras, these are relatively unexciting days, indeed.

Then, one day when thinking about my poor clients, most of whom are foreign multinationals, I started to think about the traffic and its analogies to the investment community.

The first thing I noticed was that, sitting on the ground floor, I was privy to observe the numerous machinations of local drivers and all of their near misses. As most expats here probably will agree, one of the scariest things about first arriving in Indonesia is the traffic— highly chaotic, and every minute and turn seems to be an accident in waiting.

At the time I was sitting there, the traffic was particularly bad, but nonetheless things were moving. Then, I thought to myself, what if I were to watch the same scene— the same traffic circle— from afar? Would it seem the same? So in my fit of boredom, I imagined moving from my seat to the roof of the Grand Hyatt Hotel: And in my mind's eye, I realized that what I would see would be completely different from what I observed from the ground floor of the Dome Café.

What I saw from the roof far above, looking down at the traffic was— relatively speaking to the ground floor perspective— a smooth procession of vehicles. Everybody seemed to be moving around the circle without much disruption. From that perspective, I would have made the conclusion that it would not be such a bad idea to enter the traffic circle.

I contrasted the top-down view to my close-up view from Dome Café, remembering the half dozen or so near fatal car accidents and temporary tie-ups across the circle. Generally speaking, one perspective gave the impression of chaos, the other of order.

Then I reversed the exercise. I imagined a paralyzing traffic jam. Far from above, on that imaginary rooftop, I saw a complete gridlock. Nothing seemed to be moving. I wouldn't dare even think about venturing out to the traffic circle, and would probably think about waiting until general conditions improved. On the ground level, I would also see a gridlock, but I would notice other things, as well. Perhaps I would see a few strategic points in the circle that offered an opening for motorists to move around the congested areas. Also, perhaps I am the first to notice when the gridlock would start to dissipate— much before others who, at a farther distance, would begin to see an improvement.

I then realized that my two different vantage points, and the opposite impressions they would offer me, and how those could change in counterpoint depending on the prevailing conditions, was partially applicable to how foreign investors might view a country like Indonesia.

Here I think a perfect example was how investors reacted to the fall of Soeharto in 1998. Up close, country managers certainly noticed the chaos, and had real reason for concern. Still, their reactions to the immediate fallout was not quite as sharp and in a knee-jerk fashion as those who were watching from, say, New York, London, or even closer to home, in Hong Kong. Sure, the picture was not pretty, but not as bad as those from the outside looking in thought it was.

Conversely, I remember the euphoria of the outside world in the beginning days of President Abdurrahman Wahid's administration. A moderate secular with a sterling reputation as a reformist, those from afar believed that Wahid's victory would result in a positive turning point for Indonesia. But those from the inside, for various reasons, knew better than to reach a hasty prognosis. And then, when things quickly turned for the worse, the outside world talked of an impending crisis, perhaps even an implosion of the government. Those of us on the inside, although dispirited and increasingly pessimistic, did not tend to take such an apoplectic view of Indonesia's future.

So here is my first suggested principle for you when thinking about perceptions of investment risk: The farther away the observer, the more that person's outlook is driven by sentiment, not fundamentals.

In practice, I think we can see this principle at work in numerous ways. Portfolio investors in equity markets are, for example, akin to those sitting on top of the Grand Hyatt Hotel rooftop. Based mostly in London, Hong Kong, and New York, they notice when general conditions are either good or bad. As global investors, they cast their glances far across the horizon, and see much more than just our proverbial traffic circle. And because we here in Indonesia are relatively small to other parts of the global landscape, less attention and resources are paid to the finer details. When the climate improves, they are usually the first to move in, even though we— at the ground floor— might be saying "Wait a minute. Things are improving, but there are still lot's of problems." If you could compare fundamentals to the actual condition of the road, then today you might point out that there are still lots of potholes that need fixing. But those from far above don't see the potholes. They understand that the potholes are there, but from their vantage point more important is the fact that the general conditions, i.e. the traffic flow, is getting better. This is analogous to what we know as investor sentiment.

Key Drivers: Sentiment and Fundamentals

So now I come to my second general, suggested principle: Investors are driven by two factors, namely sentiment and fundamentals. This is not a surprising notion, at least on the face of it. Until we realize, of course, that what drives our sentiment, and our perception of what the fundamentals look like, is not a uniform function across the investment community

Going back to the traffic circle analogy, general conditions— smooth flowing traffic to gridlocks— drives our sentiments. And the degree to which we feel a negative or positive sentiment towards investment is, in large part, driven by how far— or close— we are to the subject. But keep in mind that this geographic distance is not just a question of actual physical distance but of mental distance, as well.

For example, an American company may have its headquarters in New York, but because it has been in Indonesia for the last decade, its understanding of Indonesia may be very sophisticated. And so that company's reactions to changes in general conditions may be much less extreme— and based on accurate readings— than a company from Singapore that has just started operations in Indonesia.

This analysis becomes a bit more complex, however, if we consider the possibility that although the American company may have had a long presence in Indonesia, its capacity to manage and maintain its accumulative knowledge might be lacking. Hence, although the company may have been in Indonesia for several decades, and in-country management's understanding of Indonesia is excellent, that might not translate into an accurate assessment at headquarters. In fact, I have consulted many experienced country managers who complain incessantly about their main office's inability to grasp reality and inexplicable belief in what is reported on cable news networks. It seems that such corporate cultures tend to discount analyses from country managers because they believe they have a hidden agenda, and then somehow magically transfer their faith to talking heads and their edited sound bites.

Conversely, a company may have an excellent knowledge management system, but because its country managers are frequently transferred, the analysis coming out of Indonesia on current developments and trends might be lacking due to lack of in-country experience.

Quite often, I meet new country managers, and they will ask me, "Is Indonesia like Nigeria, or Russia?" In other words, until they start building up their in-country expertise, they invariably search for analogies to countries they do understand. This can often lead to disastrous results. Sometimes I will resort to near-ridiculous analogies, hoping to wake up the patient: "Actually, Indonesia is not like Nigeria or Russia. It is a bit like New York. Jakarta is like downtown Manhattan, and Aceh is like Harlem. Riots in Harlem might spook condominium dwellers on Park Avenue for a while, but for the most part those riots stay confined to Harlem. So don't worry. And oh yeah, if you were wondering about Soeharto, think about New York City Mayor Giuliani. He was very effective, and well-liked by most New Yorkers. But for God's sake you did not want to ever get on his wrong side— he could be very nasty if

he wanted.”

Having said that, what about the second key driver for investment, i.e. fundamentals? Surely, you will say, the fundamentals are the fundamentals. And, you might argue, they have an impact on sentiment.

In response to that, I would say that you are only partially right. I would also say that how investors view the fundamentals is largely a function of what industry you are in.

As a means of illustrating why I think this is so, let’s go back to the traffic circle analogy. Taking sentiment aside for a moment, imagine a road that is in perfect shape. There are no potholes. The lanes are well-defined, and those who are supposed to maintain order— the traffic police— are well-behaved. In other words, economic policy is quite good, civil society is orderly, and the government is protecting the interests of its citizens— and not acting in its own vested interests.

Now imagine what happens if the road conditions start to deteriorate. Potholes start appearing because there is little maintenance. Drivers start acting unruly and cut each other off because they are selfishly thinking about getting ahead as potholes get more numerous and larger. And the traffic police stop keeping order— instead, they start setting artificial traps so they can collect penalties from unwitting drivers trying to avoid the impending gridlock.

Let’s now think about how the players— the motorcycles, the small sedans, luxury cars, and trucks— will respond to this deteriorating situation.

First are the motorcycles. Relatively light, with small payloads, the motorcycles can be compared to labour-intensive industries. These are the industries that have the least appetite for bad road conditions, and they are the ones most likely to leave our proverbial traffic circle when deterioration first begins to affect their ability to operate. Examples include textiles, garments and sport shoes— like our motorcyclists, they are the most nimble, and find it easier to exit than, say, a truck.

Carrying the analogy even further, trucks can be compared to capital-intensive industries. Compared to the motorcycles in our traffic circle, they are better able to weather the potholes. They also carry heavier payloads, and have a much longer time horizon than their smaller counterparts. So it is in the real world of investors, where capital-intensive players have higher sunk costs, and tend to think of country risk with time horizons of 10-20 years. Hence when a country’s fundamentals start to deteriorate, the first ones to exit are the labour-intensive industries, while those who stay in for the longer haul and tough it out (within limits, of course) are the capital-intensive industries.

In conclusion, not all investors have the same appetite for risk. Oil and gas companies are risk-takers, and garment manufacturers are risk-averse. From the perspective of an oil and gas company in Indonesia today, the long-term outlook may seem very good, even though the short-term fundamentals may be quite bad and cause some pain. But for a garment manufacturer, its CEO might subscribe to Keynes’ dictum, “In the long-run, we’ re all dead.”

Green Light, Red Light

Previously, I have talked about players already inside the traffic circle, i.e. investors who are already in-country— and what drives their behavior. Think of those that stay in the circle as those who continue to invest and maintain their operations. Of course, players have the option to leave the circle, in which case they decide to leave Indonesia and look elsewhere to place their investment funds.

But what about new investors— those who have yet to invest in Indonesia?

Well, before an investor comes into the circle, he must first pass an imaginary traffic light. That light is, again, driven by two factors: sentiment and fundamentals.

When both sentiment and fundamentals are positive, the traffic light turns green. This is when everybody wants to come into the circle. There are no traffic jams, and the risks we face once on the road are relatively small. This is the ideal situation for all investors.

But what happens if sentiment starts to sour? Assuming the fundamentals are still positive, the traffic light turns yellow. Our labour-intensive industries and portfolio investors will decide to go elsewhere— they have a short-term time horizon, and can't afford a traffic jam, even if they know the fundamentals (or road conditions) are still good. But the capital-intensive industries will take a different perspective: They know there is a traffic jam, but they are still willing to enter, as long as they believe the long-term outlook for the road conditions will remain positive.

Finally, there is a red light. Sentiments have soured, and the fundamentals begin to deteriorate, as well. Now not only have labour-intensive industries decided to stay out, but the capital-intensive industries are starting to have second thoughts, also. A few capital-intensive players are still inside the circle, but the longer the fundamentals remain poor, the more likely these players will eventually leave, with the end result being an empty road.

Where is Indonesia Today?

Having finished laid out this framework for how investors perceive risk when investing in countries such as Indonesia, I hope you will excuse me for giving a short answer to the question of what investors think of Indonesia today: That, of course, depends on who you are!

However, I do think it would be useful to take note of the general traffic conditions and how the road looks. Right now, we have a yellow light. Sentiment has improved as compared to last year. For me, this is not very surprising, for President Megawati entered office when the light was red, and sentiment was near an all-time near low. So, Megawati had an interesting advantage when she first came to office: Wahid endowed her with a base of zero when it came to sentiment, and the only way was up. By saying little and acting conservatively, she has managed to instill a semblance of stability. This explains, in large part, why we have experienced a strengthening of the rupiah and Jakarta Stock Exchange.

Megawati and her team have also managed to start repairing a few potholes. The IMF and Paris Club have firmly sided with her, and there seems to be some movement on legal reform. But this is work still in progress, and a lot remains to be done. There is no certainty that the yellow light will turn green. In fact, it could just as easily turn red again.

My message today is, then, that the work must continue. Much remains to be done. A strong rupiah and stock market are not leading indicators of a sustainable recovery, and the Megawati Administration should not feel complacent with its recent victories. Otherwise, this government may find the road ahead a very lonely one, indeed.



CONFERENCE

on

THE ECONOMIC COST OF TERRORISM: INDONESIA'S RESPONSES

Tuesday, 7 May 2002
Shangri-La Hotel, Jakarta

Issues and Prospects of Terrorism Eradication in Indonesia

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Organized by
CENTRE FOR STRATEGIC AND INTERNATIONAL STUDIES
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ISSUES AND PROSPECTS OF TERRORISM ERADICATION IN INDONESIA¹

By: Prof. DR. Romli Atmasasmita²

The issue of the post-cold war terrorism and entry into the midst of the globalization *era* at this time constitutes an actual issue and demand serious considerations and measures from all countries. It appears that it is not easy to deal with these issues particularly those on an international scale and very much requires the same vision and mission and policies and coordinative measures not merely on the national and regional levels but also on the international level. The governments of Malaysia and Singapore have recently conducted arrests and detentions against the members of an international terrorism network group, and this proves that Indonesia is the next target of such terrorist network or it is entirely possible that they are already here.

In view of the provisions of international convention that set forth the matters on terrorism since 1937 up to 1999 and some United Nations Security Council resolutions concerning these issues, it is obvious that terrorism is recognized as threat to the peace and security of mankind in accordance with

Chapter VII of United Nations Charter, with legal implication namely an obligation of any country to apprehend, prosecute and punish or extradite perpetrators of terrorism. Nevertheless, the 1998 International Criminal Court/World Criminal Court did not include terrorism as one of the Court's jurisdiction, so that in terms of *expressive verbis* terrorism has not yet to acquire the legal status of an International Crime, as is the case of genocide and crimes against humanity. Even so, in law enforcement practices against terrorism, particularly in the wake of the September Eleventh 2001 incident, the United Nations Security Council has elevated the status to that of "international crime," as evidenced by the solidarity of European, Asian and African countries taking active part in tracking down and apprehension, detention and extradition of terrorists of Osama Bin Laden or Al-Qaeda followers taking

¹ The paper was delivered at the Seminar of "The Economic Cost of Terrorism: Indonesia's Responses" organized by PEG and CSIS on May 7-8, 2002 in Shangri-La Hotel Jakarta.

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place in Singapore, Malaysia, the Philippines, India, Pakistan, Somalia and Saudi Arabia.

Starting from the facts and measures of the United Nations in dealing with the recent cases of terrorism, it is obvious that the most important thing for Indonesia is how to take a stance on developments in international legal practices concerning the aforementioned terrorism issues.

The 1937, 1988 and 1999 Conventions relating to the prevention and eradication of terrorism have indicated that the provisions within these conventions does not apply to acts of terror *committed in a certain countries by **citizens of the relevant countries, except such actions still involve other jurisdictions and the victims are from such countries***, (see Article 3). Therefore, each country must be able to differentiate which actions are classified into “Domestic Terrorism” or “International terrorism”. However, the definition on terrorism has not yet accepted by the international society.

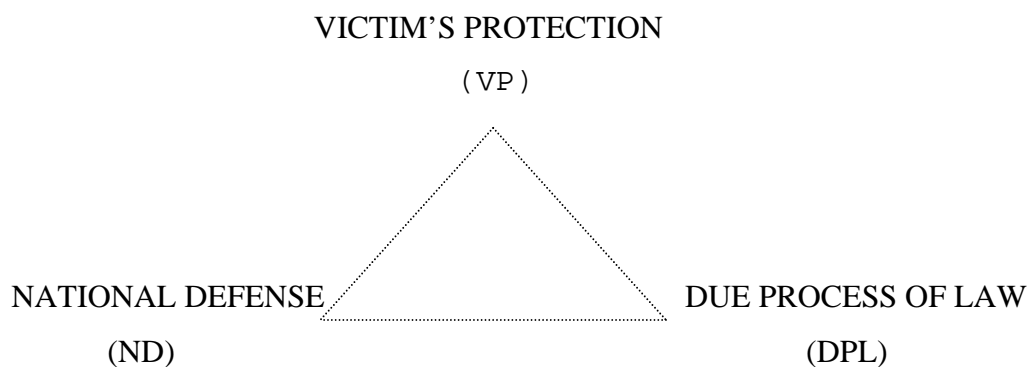
In the context of such international convention development, despite the fact that the government of Indonesia has not yet become a party state, however, it has signed the “International Convention for the Suppression of the Financing Terrorism” on September 24, 2001. The Government of Indonesia are conducting preparations to ratify such convention (1999). The legal implication of the engagement to both the convention and resolution and commitment against the terrorism eradication is that it is appropriate for the government to prepare a draft law that is able to prevent, eradicate, and control the security of the state of the Republic of Indonesia from international terrorist attacks, including the freezing of assets or funds used for terrorist activities so that, in such manner, the government of Indonesia has taken an active part in creating world peace and security and welfare of the state of the Republic of Indonesia in line with the Mandate in the Preamble of the 1945 Constitution especially in the South East Asian territory. Actually the government of Indonesia is currently deliberating a Draft Law on the Eradication of Criminal Acts of Money Laundering, which may cover the freezing of assets or funds used for terrorist activities.

In Indonesia, there is a developing opinion which purport that terrorism and terrorist activities are sufficiently covered by the Indonesian Criminal Code; where the provisions setting forth the matters of crime against public order still apply. To date, for example, the Netherlands has no Law concerning terrorism, but it deals with it through its Criminal Code.

In the context of such discourse it is necessary to consider that” domestic terrorism or terrorist action, which is domestic in nature, shall be sufficiently tackled by the criminal provisions existing in the applicable Indonesian Criminal Code.

In order to materialize a national law aiming at preventing and eradicating terrorism and comply with the international standards and national conditions, the government has agreed upon three paradigms to be considered so that the direction of such prevention and eradication may be understood by all components of Indonesian nation. The three paradigms are first, State Security and Defense; second, due process of law; and third, “victim protection”.

In using three paradigms, the government acknowledges the “Equal Distance Concept” (EqD) as follows:



The aforementioned three paradigms appear to be suitable in our transitional era especially to current values of justice and the principles of Human Rights, transparency and accountability.

September 11: Political and Security Impact and Changes in the Strategic Balance of the Asia Pacific Region

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I. Global

The impact of September 11 on the Asia Pacific region could be sensibly discussed within the context of the new global strategic development and how this will unfold into the future. This necessitates some exercises in speculation about those future developments.

This will involve an examination, mainly but not exclusively, about US future strategies. It also involves an examination of how US allies, friends, and foes will react to US future policies and strategies, and the outcome of the dynamics of the mix between those policies and strategies.

After September 11, President Bush and his administration are re-ordering their priorities and strategies around two targets. First is how to get rid of global terrorism and groups or states that support them. At the very least, the objective is to subdue them to a very large extent in order not to become a main threat to the US mainland and US interests globally. Second is how to prevent weapons of mass-destruction (WMD) to be used against the US and against US interests. This includes nuclear, chemical and biological weapons. The perpetrators are mainly state-driven or organized by the state. Thus, in the end the US will be against states that are potential actors and have the capability and the willingness to do so. In concrete terms, this means for now Iraq, who is considered as actively pursuing WMD and has the reputation to be willing to use them as they have done so in the war against Iran and the Kurds in Northern Iraq.

In the first case, namely in trying to get at al-Qaeda and the regime supporting them, namely the Taliban in Afghanistan, the US has been relatively successful in the first phase, with the support of all kinds of coalitions. But further efforts in peace-building in Afghanistan will be more relevant to show that the US has grasped the importance of coalition building in fighting global terrorism, in which military means --while important-- is only part of the effort.

The US has been willing to cooperate with allies and friends in the struggle against global terrorism, although on the military operations side, US forces has been so dominant so that a rather unilateralist attitude was visible initially. However, the military actions could only be so successful because of the support given by US allies and friends, including basis, intelligence, even logistics (AWACS from NATO, etc). Allies and friends have given a lot more support in the mopping up operations of al-Qaeda and the Taliban and in peace keeping in Afghanistan

If the US does recognize that the fight against global terrorism is long term and all encompassing, especially in intelligence exchanges and police works plus controlling financial flows, then only multilateral efforts can be successful. The US is inclined to do so, although the rhetoric could be mixed, sometimes multilateralist, and at another time unilateralist.

On the second objective, namely Iraq, however, a lot more efforts have to be done by the US before this could be palatable to a lot of allies and friends. The logic at getting to WMD is clear for US national interest. It could be a calamity if the US cannot prevent WMD attacks towards itself in the future:

Because of the belief that Iraq is able to produce them and is also willing to use them, it is only natural that the US has a contingency plan to face them. The problem is how to convince allies and friends as well, about its objective and about the method. It is important to provide reasonable evidence of Iraq's possession of WMD and the capabilities for delivery. It should also provide alternatives to get rid of Iraq's WMD, including an all out inspection by U N agencies as the first step. Only if Iraq refused to comply —which it could be expected to do, then the case to move against her would be stronger.

To be able to launch an attack against Iraq, many Arab countries need to give their support, politically but more so militarily, in the form of bases over-flights, logistics, etc. In this regard, the Israel-Palestine conflict is a real stumbling block, especially after the attack of PM Ariel Sharon to the main towns in the West Bank, in answer to a series of suicide bombings by some of the radicals Palestinian organizations. Although high-ranking officials of the Bush Administration have been saying that this conflict should not become an obstacle to prepare for regime change in Iraq, it has created a lot more complexities than meets the eyes, and at least will delay any further plans.

Because for Muslims anywhere and the Arabs particularly, the Israeli-Palestinian conflict has become a self-identification image of how badly the West has treated Muslims since the beginning of imperialism and colonialism. So, they expect a more balanced and committed policy from the US in solving the conflict.

The new developments after September II, as briefly described above, provide a basis for speculation and analysis about changes in US strategy and the US role in the future. It is widely observed that the changes have been substantial, namely from a more realist type of strategy towards a more expansive one. Before, the balance of power was more taken as the basis for US relations with other powers, but now that is looked upon as an opportunity to think more of a new era, like the era of 1945-1947 when containment policy of President Truman was formulated.

Some important Bush Administration officials now think that a more dominant role is possible for the US. Questions raised include the possibility of the US to go it alone in the world if necessary and how much change it is willing to engender inside other countries, to what end and with what means. Although not all ideas have been accepted, the overall goals of American foreign policy will be contained in the coming National Security Strategy report, which is being prepared by the National Security Council under Condoleeza Rice.

While the new agenda of US national security is to fight global terrorism and weapons of mass destruction, the domestic situation in the US has also changed. Decisions on

foreign policy are much easier to arrive at now because **it** is easier to convince the US public that foreign policy again matters

These new developments have a historical background in the older Bush Administration, when after the fall of the Berlin wall, the Secretary of Defense, Cheney, tried to come up with a new national strategy. He was even considering whether the US should not prevent other big powers from emerging so as to challenge the US, and whether the shaping and expansion of democracy should not become an objective of US foreign policy.

Cheney's team in 1990 differed from the team today. Some of the old figures are still there but they have become more experienced and more mature in their judgment. They are sharp and understand how to adjust and compromise in implementing their policies. The Iraq case will be a model of how committed they are to their old ideas and how to reach them. They are mostly on the right side of the political spectrum, but not all are unilateralist inclined. In fact, if they are getting at Iraq while not adequately prepared, they are going to damage the coalitions they have established very conscientiously. Without the coalitions, they will not succeed in their anti-terrorist fights in the long term. They want to affect a regime change in Iraq, but they know the complications and have to adjust to that and find new ways to make that possible.

On the objective of expanding democracy, they seem to be more opportunistic but are of the opinion that democratic regimes will make the efforts of the US much easier to achieve, due to the congeniality of its values and system. On preventing great powers to compete and oppose the US, they are thinking now not of "containment" like in 1948 but of "integration", which mean that the other major powers have to be persuaded to adhere to certain key ideas as to how the world operates: opposition to terrorism and WMD, support for free trade, democracy, markets. That means locking them into these policies. By building institutions to implement those policies, they will be locked in even more.

In the end, despite some wrong rhetoric, the Bush Administration officials know that they could not achieve all these objectives without coalitions of friend and allies. In that respect the right pressures from allies and friends have to be given to them. US

public opinion is very strong in supporting their policies concerning the fights against terrorism and WMD. Therefore, they should be reminded again and again by the outside of the need for coalition building to be successful.

This will not be easy, but it is not impossible and will be critically important also for the US leadership itself. Joseph Nye in his book, “The Paradox of American Power”, has stated very well that the US cannot lead the world without allies and friends. In some cases unilateralism can be accepted and should be done, especially if the survival of the country is at stake, but in many other instances multilateral approaches are more relevant and effective. This is so in particular in the economic field, where multilateralism is real between US, EU and Japan (and China that is coming up fast), or in transnational activities where the actors are many and the states are not the only ones, such as in the environment, HIV-AIDS, drugs, and illegal immigrants.

In the end the US is going to lose its “soft” power, namely the influence and attraction it has due to its values system and way of life, which have wielded so much influence and power for the US so far. If the US stresses too much on being unilateralist and being an arrogant power, a coalition of powers to balance and oppose the US, as had happened in history, might soon be established. If the US can maintain this “soft-power” then her power and influence will be more acceptable and can last a while longer into the new century

The questions that arose from September 11 are as follows: how much change has happened and how permanent will these changes be. The same questions are also being asked for the Asia Pacific region.

There are analysts who think that September 11 was so dramatic that a new era has been ushered into international relations and strategic developments, globally as well as in every region. Now the struggle is no longer between states, but between states and groups of individuals. This embodies a new form of an asymmetric conflict that will lead to new strategies and international relations. As described before, the US administration think that the change is dramatic enough so that it should aim for a much more expansionary foreign policy and strategy than only following the realist approach. They argue that this has begun as an era of “containment” before, that

through a certain transition period (last decade) will lead to “integration” in the fixture.

Others think that the effect is limited, because terrorism has been with us before and will be with us for a long time to come. It is not likely to change the underlying relations between nations. The only change caused by recent global terrorism is the means they use, their outreach and their organization capabilities. In addition, the target is the only superpower, namely the US, on the mainland or everywhere else. Otherwise, the international system being maintained by the US, EU and Japan (industrial nations known as the West), is basically still intact: Some changes will happen because of September 11, especially in the security field but the existing order will be maintained.

As usual, the reality is somewhat of a mix of both analyses. An opportunity has opened up due to September 11 for the US to lead a grand coalition not only to fight global terrorism but also to establish a new global and international order. However, for that to happen the Bush Administration has to be willing to cooperate more with its allies and friends, especially with other great powers. As Joe Nye has argued persuasively, the US is a superpower in all fields, but has equal partners in the EU and Japan in the economic field, while in transnational activities it has ample actors to deal with, including the private sector and the civil society. Although the US has a very powerful military, the fight against terrorism is mainly in intelligence and police/law enforcement cooperation plus money laundering control, where the military is not the most important element. In the end it is all encompassing struggle, including for ideas and visions.

The judgement is still out, whether the Bush Administration is able to achieve their new strategy. The Bush Administration recognizes that they have a unique opportunity, because the US public do pay attention and want to do something in foreign affairs again. The public also recognizes that this new threat will give the US and its allies and friends a chance to look anew into the role of offensive and defensive weapons system (as M.ND) and of nuclear weapons in their future defense system. This will open the door for instabilities if not well argued and consulted.

The fight against terrorism has to include efforts to overcoming the root causes in the longer term. This will take some substantial effort and intense international cooperation. And for that to be achieved the global system is going on side by side with the immediate actions against terrorism, because tackling the root causes need the support of all the existing international system, political, economic, social and even culturally which in many cases has to be improved to become effective. So, this is going to be a mixture of new actions, cooperation and if necessary of new institutions, besides an improved global system of cooperation

II. Asia Pacific

With the above as background, what can be said about the Asia Pacific region? What has really changed and what is going to continue? What is temporary and what is permanent in the region after September 11?

In the first phase of the fight against global terrorism, namely to get at al-Qaeda and the Taliban, the Bush Administration was rather successful, based on cooperation and coalition building with many allies and friends. In particular, relations with other great powers and with a number of Muslim countries have improved.

Russia has established their credentials particularly in getting closer to the West and the US, especially in allowing the bases to be established in Central Asia as well as through intelligence support. Chechna has almost been forgotten and a new agreement on cooperation with NATO is being finalized. Japan has strengthened the alliance by a new law on security and by sending some supporting ships to the Middle East (the first Japan's SDF involvement outside her periphery). This move, considered a first step towards becoming a "normal" country has been acquiesced by her neighbors. China, which also faces the threat of global terrorism and for desiring to establish normal relations with the USA, also cooperated especially in political support and intelligence exchanges. India, who was preparing for some time to be closer to the US strategically, got a better chance and has made use of the events to support the US, while expecting US support for Kashmir.

Among the Muslim countries, Pakistan has supported the US to the maximum, despite

some internal opposition, through intelligence, as a staging base for military operations, politically, etc. And so do other countries in the Middle East with their military bases, although more limited than Pakistan, but politically the support from Muslim countries has been crucial

In the Asia Pacific, political support has been given at the APEC Summit, at the ASEAN Summit, and the ASEAN + 3 (China, Japan, and Korea) Summit. Moreover, ASEAN members, particularly Indonesia, Malaysia and the Philippines, started to cooperate among themselves to fight global terrorism in the region. This cooperation is especially among intelligence and law enforcement agencies, as well as among the military. So, the September 11 has strengthened US presence and cooperation with East Asia in many layers; region wide (APEC, ARF), sub-region wide (ASEAN or part of it) and bilaterally (especially in the intelligence, police and money laundering parts).

But since the region is so wide and diverse, the intensity and variety of cooperation might differ from one sub-region to another and from one country to another. The main reasons are: domestic priorities of the countries in the Asia Pacific might differ from those of the US and from each other. While at this stage the US is obsessed and is running “amok”, understandably so due to the attacks to her symbol of power and to so many innocent people, other countries might have priorities that are as important to their national interest as facing those terrorist acts. They also have experienced and faced various types of terrorism, although not on the same magnitude as this new global one by Al-Qaeda.

Domestic complexities could constrain them from cooperating publicly or openly, especially in the case of countries with Muslim majorities such as Indonesia and Malaysia. Others face Muslim insurgencies and are in need of assistance, such is the case of the Philippines. Still other countries in Southeast Asia that have very small numbers of Muslims such as Vietnam, Laos, Cambodia, Myanmar, and even Thailand have been less concerned domestically but came on board rather late and are involved mainly in political terms. The challenge for the US leadership in this fight is how to reconcile her own priorities with those of the other parties, which might differ in their intensity.

Take Indonesia as an example. The government is weak and law enforcement agencies are also weak and corrupt. The crisis has created an enormous challenge to dealing with poverty, employment, regional insurgencies, law and order, restructuring the economy, huge debt (domestic and foreign), and weak governance, to name a few. Some small radical Muslim groups have been agitating against the US in the fight against terrorism. However, the large mainstream Muslim organizations such as NU and Muhammadiyah are not supporting these groups. As for the government and the US, the best course is to give the support to mainstream Muslim organizations to lead the Muslim community towards modernization, moderation, openness and democratic values.

In the meantime the government has to be firm on law and order problems and strengthen the police (and the military when necessary), to take legal actions against any criminal acts or illegal agitations and activities by any radical group. NU and Muhammadiyah support such actions. The police need to have better training, and here is where the US can assist. This includes a gradual fostering of normal relations with the military. Intelligence cooperation that has been established should also be strengthened. With these policies, the US strengthens the hands of the government in dealing with global terrorism but also at a pace and steps comfortable for them. In the end the best contribution the Indonesian government and society can give to the fight against global terrorism is to keep the majority of Muslims, moderate, open and democratic. As stated before, the struggle against global terrorism is in the end a struggle for ideas and visions.

If Indonesia as the largest Muslim country could show to the world and especially other Muslim nations how Muslims can be moderate, open and democratic and developing economically at the same time, this should give a tremendous boost to the struggle for the right ideas, vision and soul of Islam.

The Philippines situation differs from Indonesia. They have a problem of Muslim insurgencies in the South. Although Muslims consist of less than 10% of the populace, at present they are in a majority in a few districts in the Southern Philippines. The problem of Abu Sayyaf is a problem of criminality and extortion plus

kidnapping. They have had relations before with al-Qaeda cells and that relationship could be revived. More importantly, however, is the MILE (Moro Islamic Liberation Front) and the government is currently negotiating a political deal with them. It is more worrying if they are used by al-Qaeda, because they are much stronger than the Abu Sayyaf group.

It is understandable that the Philippines government has asked for US military and troops support. They need it badly and they need to get the political, economic and financial support from the US to be able to shape up their military. Besides, they have had US military bases that ended in the mid 1990s with their transfer to the Philippines authority. So there is less political opposition there. But at the same time, US troops have to be careful, since MILF territory is included in the terms of the cooperation. Maybe the most relevant effort in their cooperation is to train Philippine troops and to support them logistically.

PM Mahathir has brilliantly made use of September 11 for his political revival and initiative against PAS. The main problem he might be facing now is how to reform the “madrasah” schools that have been developed along the Pakistan model and are mainly under PAS supervision and influence. Indonesia is completely different in this regard because from the beginning Muhammadiyah has never had only “Muslim teaching schools”, but has offered normal schools with Muslim teaching, while NU’s *pesantren* has been opened up by Gus Dur (ex President Wahid) to also teach subjects as in normal schools.

Another main task for Mahathir is to clean his party and the government from the corruption accusations by PAS and other opposition parties. A further task is to prepare for a political successor and to gradually open up the political system. So, while political stability is assured in the medium term, in the longer term some real reforms are still in order.

In the case of Singapore, it was a shock for the leadership when they learn about Jemaah Islamiyah (JI) activities and their plan to attack US interests in Singapore and other parts of the region. Political stability and security is the mainstay of Singapore’s attractiveness to foreign investment and such terrorist activities could damage that

credibility. That is why the leadership reacted vehemently against these activities. It also showed that regional terrorism induced by global ones, is already present in South East Asia

The leadership in Singapore is more active in fighting terrorism and in lining themselves closely with the US in fighting global terrorism. But as the US should understand, Singapore too should learn to appreciate the diversities in political Islam, should not become paranoia about them. To learn more about Islam is an important challenge for the US and equally for Singapore leaders. As is the case in Indonesia, it is the mainstream Muslims that should be encouraged to try to influence and guide the Muslim communities towards moderation and openness through democratic means.

It is important to distinguish domestic conflicts such as political strife, insurgencies, ethnic or religious conflicts from global terrorism. These domestic conflicts have their roots in domestic social-political and economic problems and should be also solved through domestic socio-political, economic, and security approaches. The rule of law and human rights concerns should be attended to as they should be in the global fight against global terrorism. Exceptions can be made in survival cases, but used only in a limited fashion, temporarily and with adequate transparency to prevent abuses.

In North East Asia the key questions are as follows: Are efforts against terrorism going to change the strategic picture permanently or not, and what complications are to be faced in fighting global terrorism in this sub region?

In the Korean peninsula, the fight against terrorism has brought about some complications because North Korea, who has been considered a member of the axis of evil” by President Bush and has been given new pressures by the US, will complicate the “sunshine” policies of President Kim Dae-Jung. In fairness, that policy has had limited results so far for South Korea. That policy was never really popular in South Korea and has been opposed by the opposition party. In addition, there are some important obligations that have yet to be fulfilled by North Korea, and this year will be crucial for those obligations to be met.

Bush’s accusation was mainly directed at North Korea’s political system that put so

much misery to its own people, the possibility of North Korea not abiding by the non-proliferation agreements she has signed and by the sales of missiles technology and WMD to rogue countries that could endanger the region and the US (indirectly). The readiness of the North to talk again with the US is seen as a result of the pressures by the Bush Administration.

In the case of Japan the strengthening of the alliance and the opening for Japan to become a “normal” country are important developments. However, for permanency, Japan also has to undertake political and economic reforms and be again on par with the US economy in productivity and vitality. For that to happen, political reforms have to be deepened.

In China’s case, it should be a lot more difficult to maintain the earlier goodwill between China and the US due to the September 11 attack, because there are so many tough problems between the two. Basically, this is a challenge for the two big countries, one a superpower and the other becoming one in the future to deal with each other normally. There is not enough trust and confidence between the two peoples and the two leaderships that could easily bridge this divide.

The most important question is Taiwan, but other matters such as sophisticated arms sales and technology transfers by China to other countries, especially those considered rogue ones by the US such as Iran and Iraq, human rights violations and religious freedom are also important issues in the relationship. Even US presence in central Asia, which has been accepted so far, could arouse questions about the encirclement of China as well as the increase of US presence in East Asia.

In the meantime, the rhetoric of the relationship that has been brittle earlier, has calmed down since September 11, and constant relations at the highest level have been maintained despite some serious issues on Taiwan, especially sophisticated arms sales to Taiwan and the visits of Taiwan’s high ranking defense officials to the US. On the other hand visits of China’s leaders to countries considered to be supporting terrorist also created question marks in the US. By becoming a member of the WTO, China appears to have become more and more a conservative member of the regional and international community by willing to abide by international rules as well as the

regional order and institutions, which augurs well for future relations with the US.

The impact of September 11 is somewhat more limited to the US-China relationship. However, while the atmospherics of September 11 is still strong, both sides have to establish much more personal relations at the highest level and in improving public opinions about each other. Most important is that the US does not see China as the new “threat” or as a substitute for the former Soviet Union.

The changes in the Asia Pacific due to September 11 are among other things:

- US leadership is becoming more assertive in the Asia Pacific after being somewhat dormant since the end of the Cold War. What this will mean to the region is still unclear, because how this administration is going to change things will be decisive. Will this new leadership be more positive towards cooperation and more multilateral inclined due to the need for coalition building in fighting terrorism? Since some of the members of the Bush team are bright people and quite pragmatic, although ideologically on the right side of the US political spectrum, there is hope that they want to become more patient to give breathing space to some countries, particularly the sub-region of South East Asia, to face global terrorism on their own terms, since the priorities are varied and domestic complications are to be recognized.
- On North Asia, US more assertive leadership could be a problem in relation to North Korea, but this has to be settled between the two countries themselves. In relation to China’s ascendancy, the US might be prone to misinterpreting it, although it might not be all China’s problem. So, in North East Asia while the existing relations might be maintained, a more assertive USA, might bring about new tensions. But a more multilateralist attitude on the part of the US instead, might alleviate some of the existing tensions.
- Regional efforts to face global terrorism will be important. First, this is more palatable for domestic constituencies in individual countries and helps alleviate more pressures by the USA to do all kinds of things that is not a priority for individual countries or the region or sub-region. Regional cooperation will be

more important if US becomes more unilateralist inclined in the future. The request by the US to cooperate against global terrorism will put additional pressures on regional institutions to get their act together.

- Each of the countries in the Asia Pacific has to reconcile its own priorities with the need to fight global terrorism. In most cases US support might be important, especially cooperating and supporting in the fields of intelligence, police works and money laundering prevention. Consolidating each society should be the main task of individual countries, especially Muslim ones. They have the difficult but critical task to influence political islam to become moderate, open and democratic.
- In the end the struggle is really for ideas and visions. In this case, September 11 has also been a wake up call for many Muslim countries as well. Their challenge is to make Islam a religion of peace, moderation, openness, and democracy, and to make the world understand and accept it. So, there is a new challenge for every individual country after September 11, namely to keep their country together, peaceful and developing well to be able to withstand extremism of ideas and religions.

“THE ECONOMIC COST OF TERRORISM: Indonesia’s Response”

Organized by:

**Centre for Strategic and International Studies (CSIS)
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**Tuesday, May 7, 2002
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SESSION II

WHAT IS TO BE DONE?

Mr. Sujata opens the session in Bahasa and asks the audience to use either English or Bahasa Indonesia. He apologizes that Mr. S.B. Judono could not attend the conference to deliver his ideas. The chairman also introduces the five speakers. He also mentions that the session he chaired will be focused on exploring concrete measures that can be taken in combating terrorism.

1. Money Laundering, Terrorism and the OECD Standards

Jerry W. Rowe

Mr. Rowe thanks the organizing committee for inviting him to share his view on the topic. The Indonesia law on money laundering that already putting into effect is a first necessary step in combating terrorism. Since 1999, all countries have been encouraged adopting the law on suppressing the financial source of terrorism. However, this financial aspect of terrorism is not well understood. The first step that individual countries respond is to strengthening anti-money laundering regime by enforcing anti-money laundering law. The second is to understand the network of terrorist groups within or outside the country; the third is the immigration aspect.

The importance of combating money laundering is to curb the financial source of criminal activities. Fighting money launderers and strengthening anti-money laundering efforts globally will reduce financial crime by depriving criminals of the means to commit other serious crime. It is also the question of fair taxation as the criminals using money laundering to hide money from tax authorities. However, there are differences between organized crime and terrorist activities. While organized crime groups seek monetary gain, terrorist groups usually look for non-financial objectives, such as publicity and political influence.

The speaker sets out several steps that can be recommended to Indonesia. Indonesia needs to enhance its bilateral and multilateral cooperation, through treaties and so on, to combat terrorism. Mr. Rowe also recommends enhancing the existing money laundering law. In addition, Indonesia must enhance surveillance

on cross-border activities or transactions. In the context of the money laundering law, the principle of 'knowing more your customer' must also be strengthened, so that banks, for example, can play an active part in implementing the money laundering law.

Indonesia needs to ratify UN Convention on Combating Terrorism and Suppressing The Financial Source of Terrorism altogether. Strengthening institutional capacity such as immigration staff, police and so on must also be put on high priority.

2. ASEAN Countries Efforts to Curb Abuses of Their Financial Systems

Koid Swee Lian

Mrs. Koid defines money laundering as a process of converting cash/property which is derived from criminal activities to give it a legitimate appearance. The speaker mentions a rather different phenomenon that in some countries there are some form of the so-called criminalization of financial activity. For example, some legitimately raised fund is channeled to terrorist activities. It then can be categorized as the abuse of financial system (or financing terrorism).

Mrs. Koid gives several reason of why the abuse of financial system has to be combated including that letting money laundering to continue can damage the integrity of a financial system and in the end it cause reputation damage. If this happens, a country's financial system will suffer from counter-measures taken by international financial community.

The speaker also delineates some international initiatives regarding this issue. United Nations (UN) initiative, through the General Assembly, has urged all states to establish a legal framework. The legislative framework set out by the General Assembly (GA) proposes that it should cover three steps: (a) identification, freezing of money laundering activities; (b) international cooperation, that may take form of mutual legal assistance in money laundering cases; (c) inclusion of the crime of money laundering in mutual legal assistance agreement

Another concrete measure initiated by the UN is the UN GA Financial and Regulatory Regime that recommend the implementation of several technical measures that include the application of customer identification and verification requirements by applying the principle of 'know your customer; good financial record-keeping and law enforcement including effective detention, extradition and sharing information mechanism.

According to the speaker, Indonesia does not compliant with the 28 key Financial Action Task Force (FATF) recommendations so that FATF has listed Indonesia in Non-Cooperative Countries and Territories (NCCTS). The task force is set up by the G-7 industrialized countries and has formulated 40 recommendations for its 29 members to deter and detect money laundering. FATF may urge its members to take counter measures to the countries listed in NCCTS such as restricting or imposing conditions on financial transaction. The speaker continues to explain that money laundering can be used to track the activities of terrorist groups. In the

regional level, ASEAN Regional Forum (ARF) has started to work together in dealing with the issue. Almost all of ASEAN members have money-laundering law in place and only 4 members that have not ratified the 1988 Vienna Convention.

3. Indonesia's Bank Secrecy and Money Laundering Laws

Sutan Remy

Mr. Sutan Remy starts with questioning whether the Law no. 15/2002 on Money Laundering collides with the Law No. 10/1998 on the bank secrecy. Because the main factor behind money laundering activities that needs to be taken into account is the secrecy of bank. Previously, money laundering was not considered a crime as many business groups commit it. According to the speaker, there are two approaches regarding money laundering that common among countries in the world. The first group regulates money laundering in the civil law, as a case of violation of bank secrecy, which is common in the commonwealth states. The second group regulates the violation of bank secrecy under the criminal law, such as Indonesia.

In Indonesian law, it is clearly stated that a bank obliges to keep the secrecy of its client and its client deposits. A depositor may sue if he feels that the bank fails to fulfill this obligation. However, there are a number of exceptions in which the government has a right to force the bank to abandon the obligation to keep information confidential. It can be abandoned in some cases: (1) in the interest of tax collection; (2) in the interest of debt settlement; (3) in the interest of a court proceeding in a criminal case; (3) in a civil court case between the bank and its client; (5) in the case of the exchange of inter-bank transaction.

Violation of the bank secrecy will result in at least two years imprisonment and a fine of minimum ten billion rupiah for the official or bank employee involved. In relations with the provision of the law, requesting for information must be made in written form to board of judges. In addition, the head of regional police must sign the letter. In short, written letter must be present for the bank to open the information on an account holder.

The speaker realizes that the extermination of the money laundering practices in Indonesia can not be effective should the bank secrecy still be applicable, as stipulated in the banking law, against law enforcers such as police, the office of the public prosecutors and judges performing the investigations, legal proceedings and examinations of the criminal offenses of money laundering. Meanwhile, under the Law No.15/2002, a bank must report any suspicious transaction to the police and also transaction of more than 100 million in one day if the bank finds it unusual for the account holder.

However, Mr. Remy states that it is a breakthrough toward the war against money laundering made by the Indonesian government and the Indonesian parliament.

Comments by Panel

1. Sunarjati Hartono

It is difficult to go through the main problem of terrorism. Therefore we need to discuss more than only the law of money laundering. First of all we have to clearly define what is terrorism. We need to focus more on the main principle that terrorists never differentiate civilian from their political opponents. The question that comes up is that why we condemn terrorism.

The answer will be: (1). Terrorists are against humanity; their action is conducted arbitrarily to be able to influence their target group; (2). We also condemn terrorism action because it directs its actions toward civilian to follow their will; (3) Terrorism actions sometimes create harm, damages in a large scale, as can be seen in Palestine, Afghan and also New York or Washington; (4). We continue with the feeling of fear that one time the similar thing will happen and we will become a victim.

Terrorism is caused by desperate actions by people who struggle to be heard. In the last 30 years, in international conventions, the third world countries are being forced by multinational corporations to create one market place and in the end will end the nation-state era. Therefore, globalization can be seen as harming the existence of the developing countries that are struggling to defend their nation. So what we need is holistic, systemic legal, judicial, integral reform. In this case it will take very long time to accomplish the reform.

2. Yunus Husein

Mr. Husein starts with stating that we need to understand the causes of terrorism and money laundering. As other speaker raises it that Indonesia is entered in the blacklist of countries that are perceived as not cooperative to the global efforts in combating money laundering. It is because there is a loophole in our financial services. Therefore, we need to implement a healthy financial system as stipulates by the law.

Among the weaknesses are: first, the confusion creates by the implementation of the Law No. 15/2002 and the Law No. 10/1998; second, The lack of supervision in implementing the Laws, and hence the political will to implement the Law comprehensively; third, we lack of international cooperation. For example, we don't have sufficient extradition treaties with other countries that specifically regulate the crime of money laundering; and fourth, therefore we are lacking of technical capacity to combat terrorism and to curb money-laundering practices. In other words, we don't have good human resources to decisively combat all the problems that may stem from the issue of terrorism and money laundering activities. Another weakness is non-financial weaknesses. For instance, a bank does not really know whom behind a company, or who is the principal investor.

The speaker also admits that there are a lot of regulations that are recommended by FATF that Indonesia has not compliant with. Therefore, it represents the absence of a sense of urgency on the Indonesian part to curb the money laundering activities. By not taking the recommendation, Indonesia is also lacking the international cooperation. It is expected that by joining international groups, Indonesia might learn and share any information needed in tracking the suspicious transfer of money. Other international cooperation can be done in more informal way, such as intelligence gathering and bilateral cooperation.

The speaker gives another reason why Indonesia is on the list of NCCTS. The speaker believes that it is also the problem of coordination. The speaker reveals a fact that Indonesia has not filled in the questionnaire given by the FATF to assess the compliance of all states because no institution has been given specific authority to represent Indonesia, whether Finance Department or Department of Justice and Human Rights.

To be able to pursue the crime under this law, the amount of money in one transaction that needs to be reported is 500 million rupiah (US\$ 50,000). The unusually high reporting threshold may create an opportunity for those involved in money laundering, especially where the transactions are less than 500 million rupiah.

Discussion

Q. Mr. Hasnan Habib

First question, regarding the FATF, which particular Vienna Convention mentioned by Mr. Rowe? Is it feasible to go on with unilateral action while at the same time the US is withdrawing from many unilateral agreement. Second question, why the threshold for investigating money is only 50,000 US\$?

To Mrs Koid: what constitute crime in her definition about money laundering? Second, what is the importance of NCCTS. Third, what does it mean by terrorist asset, as the definition of terrorism has not yet been agreed?

To Mr. Yunus: Why there are weaknesses in the Law if Indonesia received international assistance in the drafting of the current money laundering law?

Q. Mr. Hadi Soesastro

The speaker stated that bank must report to the authority if they sense a suspicious transaction. How if it is the banks themselves who organize money laundering?

Q. Mr. Soedji

Does the Law on Money Laundering contradict the Law of the independency of the central bank?

Q. Mrs. Tati Harsoyo

The law on the secrecy of bank in Switzerland can be negotiated on a bilateral basis with the government.

Are there any possibilities for the central bank to investigate suspicious transaction and to whom the central bank can report the suspicion for further investigation?

A. *Mr. Rowe*

FATF has addressed the issue since 1999 by giving 40 recommendations. Convention 1988

A. *Mrs Koid*

Countries are welcomed to include any crime within their own country that can be related to money laundering activities. The NCCTs membership is not open to every country. The action to identify terrorist assets the participant shall quickly freeze terrorist asset in accordance with their own national legal system.

A. *Mr Yunus*

Indonesia receives international assistance in formulating the money laundering law, including from the APG. The amount of 500 million was given by the Indonesian parliament during the final drafting of the bill.

A. *Mr. Remy*

Indonesia's money laundering law was made to fulfill the requirement made by the Letter Of Intent between the Indonesian government and the IMIF. In the drafting, it was initially stated that the money involved comes from criminal activities. Then, it was agreed to list several kind of criminal activities, but gambling, fraud etc are not included. So, it is a dilemma whether to specify the criminal activities or not. Regarding the amount of 500 million, it is because that the parliament thinks that it will be very difficult for banks to report every transaction of 100 million rupiah. As Indonesia is still a "cash-society", 100 million is considered insignificant. So the amount of 500 million comes as a compromise.

Before the money laundering law was put into effect, money laundering is not a crime so it is difficult to say whether money laundering is already occurring in Indonesia in a legal sense. According to the money laundering law, both the depositor and also bank will be held responsible. The bank will not be prosecuted if it has performed its obligation to report any suspicious transaction.

A. *Mrs. Sunarjati*

The law produced during the reform era in many cases is worse than the law produced during the previous authoritarian era. The democratic atmosphere requires that drafting of bill in the parliament must involve more people. As result, the law produced is a result of compromise among the competing political interest in the parliament, rather than a result of serious efforts to achieve the best legislation.

A. *Yunus Husein*

Does not provide answer to the question on the relation between the Law on the Central Bank's secrecy and the Law on Money Laundering.

A. *Mr. Remy*

Indonesia needs the law on money laundering not because the IIMF imposes it. But it is also a growing concern in the world financial system to establish a healthy financial system. We should also concern with a state that already has money laundering law but not cooperative in combating it with other countries, such as Singapore that is always reluctant to implement extradition treaty regarding the case of money laundering.

The bank should report any suspicious transaction to *Pusat Pelaporan Dan Analisis Transaksi Keuangan* (Center for Financial Report and Transaction Analysis), as stipulated by Article 33 of The Law No. 15/2002 on the Criminal Offenses of Money Laundering. For the time being, until the Center established, the Indonesian Central Bank serves the function.

Mr. Sujata closes the session at 17.30 pm.



CONFERENCE

on

THE ECONOMIC COST OF TERRORISM: INDONESIA'S RESPONSES

Tuesday, 7 May 2002
Shangri-La Hotel, Jakarta

OECD Standards on Money Laundering And Terrorist Financing

JERRY W. ROWE

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Introduction

Recently the People's Legislative Assembly of Indonesia enacted a money laundering law to address the large amount of proceeds generated by serious crimes committed in Indonesia as well as outside of its borders. This law incorporates many of the recommendations that have been developed and issued by the Financial Action Task Force (FAIF), an intergovernmental body created by the G-7 in 1989 for the purpose of developing and promoting policies to combat money laundering.

This paper discusses the recommendations of FATF and offers insight into the next phase of combating money laundering and terrorist financing in Indonesia.

Money Laundering

Definition¹

With few exceptions, criminals are motivated by one thing-profit. Greed drives the criminal, and the end result is that illegally gained money must be introduced into the nation's legitimate financial systems.

Money laundering generally involves a series of multiple transactions used to disguise the source of financial assets so that those assets may be used without compromising the criminals who seek to use the funds. These transactions typically fall into three stages: (1) Placement, the process of placing, through deposits, wire transfers, or other means, unlawful proceeds into financial institutions; (2) Layering, the process of separating the proceeds of criminal activity from their origin through the use of layers of complex financial transactions; and (3) Integration, the process of using an apparently legitimate transaction to disguise the illicit proceeds. Through this process the criminal tries to transform the monetary proceeds derived from illicit activities into funds with an apparently legal source.

In other words, money laundering involves disguising financial assets so they can be used without detection of the illegal activity that produced them. Through money laundering, the criminal transforms the monetary proceeds derived from criminal activity into funds with an apparently legal source.

Why We Must Combat Money Laundering²

Money laundering is organized crime's way of trying to disprove the adage that "crime doesn't pay." It is an attempt to assure drug dealers, illegal arms dealers, corrupt public officials and other criminals that they can hide their profits and to provide them the fuel to operate and expand their criminal enterprises. Fighting money launderers and strengthening anti-money laundering efforts globally will reduce financial crime by depriving criminals of the means to commit other serious crimes. To a lesser extent, strengthening anti-money laundering regimes, particularly in the areas of identifying the originators of international wire transfers, will impact terrorist financing as well. At a minimum, strong anti-money laundering measures help to create a body of evidence that exposes criminal behavior and help law

¹ International Narcotics control Strategy Report March 2001, Money Laundering and Financial crimes, <http://www.state.gov/g/inl/rls/nrcrpt/2001/rpt/>

² Ibid.

enforcement identify violators and build cases against them that lead to their arrests, convictions and seizures of their assets.

Modern financial systems permit criminals to transfer millions of dollars instantly, using personal computers and satellite dishes. Money is laundered through currency exchange houses, stock brokerage houses, gold dealers, casinos, automobile dealerships, insurance companies, and trading companies. Private banking facilities, offshore banking, shell corporations, free trade zones, wire systems, and trade financing all have the ability to mask illegal activities. In so doing, criminals manipulate financial systems throughout the world. This process has devastating social consequences. For one thing, money laundering provides the fuel for drug dealers, terrorists, arms dealers, and other criminals to operate and expand their criminal enterprises. We know that criminals manipulate worldwide financial systems to further a wide range of illicit activities.

Nations around the world are also victims of tax evasion schemes that use various financial centers and their bank secrecy laws to hide money from tax authorities, undermining legitimate tax collection. Financial centers that have strong bank secrecy laws and weak corporate formation regulations, and that do not cooperate in tax inquiries from foreign governments, are found worldwide. These financial centers, known as “tax havens,” thrive in providing sanctuary for the deposit of monies from individuals and businesses that evade the payment of taxes in their home jurisdictions and allow them to keep the money they have deposited from the knowledge of tax authorities.

Unchecked, money laundering can erode the integrity of a nation’s financial institutions. Due to the high integration of capital markets, money laundering adversely affects currencies and interest rates as launderers reinvest funds where their schemes are less likely to be detected, rather than where rates of return are higher. Money launderers also negatively impact jurisdictions by reducing tax revenues through underground economies, competing unfairly with legitimate businesses, damaging financial systems, and disrupting economic development. Ultimately, laundered money flows into global financial systems where it can work to undermine national economies and currencies.

There is now worldwide recognition that we must deal firmly and effectively with increasingly elusive, well-financed and technologically adept criminals and terrorists who are determined to use every means available to subvert the financial systems that are the cornerstone of legitimate international commerce. The continued abuse of some offshore financial centers, the proliferation of online Internet banking and the widespread use of underground banks and money-changers highlight the importance of using new technologies and strong strategies to combat money laundering and terrorist financing schemes.

International Terrorism Financing³

Terrorist groups differ from other criminal networks in the motive behind their crimes. While drug traffickers and organized crime groups primarily seek monetary

³ International Narcotics control Strategy Report March 2001, Money Laundering and Financial crimes, <http://www.state.gov/g/inl/rls/nrcrpt/2001/rpt/>

gain, terrorist groups usually seek non-financial goals, such as publicity and political influence. Terrorism is a means to these ends. Terrorist financing also differs from money laundering in other respects. Ordinarily, criminal activity produces the funds and other proceeds that money launderers disguise so that the funds can be used for legitimate or criminal purposes. Funds that support terrorist activity are generated primarily through fundraising—often through legal non-profit entities, although terrorist groups often obtain funds from criminal activities as well. Because terrorist activity requires very little money (the attacks on the World Trade Center and the Pentagon are estimated to have cost a little more than half a million dollars), the amounts of money that individual terrorist cells or their members seek to disguise is substantially less compared to that laundered by organized crime and drug kingpins. And it is the latter for which anti-money laundering tools were initially created. The investigation of terrorist financing is requiring law enforcement and regulatory officials to use existing anti-money laundering laws in altogether new ways. And it will require stronger international anti-money laundering enforcement regimes.

Small Sums With Big Effects

While they do not seek financial gain as a sole end, international terrorist groups need money to attract adherents and to support their activities. Some terrorist organizations also need funds for media campaigns, to buy political influence, and to undertake social projects aimed at maintaining membership and attracting sympathetic supporters. Often, terrorists also rely in part on funds gained from traditional crime such as robbery, kidnapping for ransom, drug trafficking, extortion, document forgery, currency and merchandise counterfeiting, and smuggling. Terrorists can then divert some of the proceeds of these criminal activities to their terrorist efforts.

A substantial portion of the terrorists' funding comes from contributors to non- — profit organizations, some of who know the intended purpose of their contribution and some of whom do not. In this key respect, terrorism financing contrasts with the financing of a drug trafficking network, which obtains virtually all of its funding from illegal activities.

Origins of Financial Support⁴

Terrorist groups commingle illicit revenues with legitimate funds drawn from profits from commercial enterprises and donations from witting and unwitting sympathizers. They tap a range of sources for their financial support including:

- ✓ ***Otherwise Legitimate Commercial Enterprises.*** Terrorist groups earn profits from businesses they own. They also secure donations from sympathetic entrepreneurs.
- ✓ ***Social and Religious Organizations.*** Since the early 1990s, terrorist groups have relied increasingly on donations from social and religious organizations for financial support.

⁴ International Narcotics control Strategy Report March 2001, Money Laundering and Financial crimes, <http://www.state.gov/g/inl/rls/nrcrpt/2001/rpt/>

- ✓ **State Sponsors.** Several rogue nations—Cuba, Iran, Iraq, Libya, North Korea, Sudan, and Syria—have provided material assistance, financial support or other resources to terrorists.

Moving Terrorist Money

Tracking terrorist financial transactions is more difficult than following the money trails of mainstream criminal groups. While many organized crime groups are adept at concealing their wealth and cash flows for long periods of time, their involvement in the physical trade of illicit drugs, arms, and other commodities often exposes the revenues and expenditures connected to these illegal dealings. In contrast, terrorist actions generally are comparatively inexpensive and their financing is often overshadowed by the larger financial resources allocated for the group's political and social activities, making it more difficult to uncover the illicit nexus.

Terrorist groups use a variety of means to move their funds, including:

- ✓ **Currency Transport.** Cash couriered by operatives is difficult to track because there is no paper trail.
- ✓ **Traditional Financial Institutions.** The international nature of most foreign terrorist groups forces them to rely on banks and other financial institutions.
- ✓ **Islamic Banks.** Banks that operate in line with Islamic law, which prohibits the payment of interest and certain other activities, have proliferated throughout Africa, Asia and the Middle East since the mid-1970s. In most instances, these banks simply are not required to adhere to a wide range of regulations normally imposed on commercial banks. Islamic banks are often not subject to any regulatory and supervisory scrutiny by bank regulators, and thus, do not undergo periodic bank examinations or inspections. While these banks may voluntarily comply with banking regulations and in particular, anti-money laundering guidelines, there is often no control mechanism to ensure such compliance. Some of the largest Islamic financial institutions now operate investment houses in Europe and elsewhere.
- ✓ **Money Changers.** Moneychangers play a major role in transferring funds in Asia, the Americas, the Middle East, and other regions. Their presence is largest in countries where cash is an accepted means to finalize business deals and where large numbers of expatriates work to remit funds to family abroad.
- ✓ **Underground Bankers.** Commonly referred to as alternative remittance systems, such as the Hawala or Hundi, underground bankers are prevalent throughout Asia and the Middle East.

Financial Action Task Force (FATF) on Money Laundering⁵

What is it?

The Financial Action Task Force on Money Laundering (FATF) is an inter-governmental body whose purpose is the development and promotion of policies to combat money laundering -- the processing of criminal proceeds in order to disguise their illegal origin. These policies aim to prevent such proceeds from being utilized in future criminal activities and from affecting legitimate economic activities.

Who are the Members?

The FATE currently consists of 29 countries⁶ and two international organizations, the European Commission and the Gulf Cooperation Council. Its membership includes the major financial center countries of Europe, North and South America, and Asia. It is a multi-disciplinary body - as is essential in dealing with money laundering - bringing together the policy-making power of legal, financial and law enforcement experts.

Why Is It Important?

In addition to developing anti-money laundering measures the FATF encourages jurisdictions to adopt money laundering controls through the passage of legislation and polices designed to not only prevent proceeds of crime from being used to further criminal activities, but to facilitate the detection, investigation and prosecution of money laundering and terrorism on an international basis.

FATF Forty Recommendations⁷

This need to cover all relevant aspects of the fight against money laundering is reflected in the scope of the Forty FATF Recommendations -- the measures that the Task Force has agreed to implement and which all countries are encouraged to adopt. The Recommendations were originally drawn up in 1990. In 1996, the Forty Recommendations were revised to take into account the experience gained over the previous six years and to reflect the changes, which have occurred in the money-laundering problem.

Additionally, FATF has developed and published a series of interpretative notes that expand and further clarify the 40 Recommendations.

Annually, the FATF also publishes a Topology Report that provides information on money laundering schemes and trends identified by member countries.

⁵ FATF Web page, <http://www1.oecd.org/fatf/>

⁶ The twenty-nine FATF member countries and governments are: Argentina; Australia; Austria; Belgium; Brazil; Canada; Denmark; Finland; France; Germany; Greece; Hong Kong, china; Iceland; Ireland; Italy; Japan; Luxembourg; Mexico; the Kingdom of the Netherlands; New Zealand; Norway; Portugal; Singapore; Spain; Sweden; Switzerland; Turkey; the United Kingdom; and the United States.

⁷ Available at Web page FATF Web page, <http://www1.oecd.org/fatf/>

Terrorist Financing Recommendations⁸

Subsequent to the terrorist attacks in the United States, FATF issued eight additional recommendations which, when combined with the EATF Forty Recommendations on money laundering, set out the basic framework to detect, prevent and suppress the financing of terrorism and terrorist acts.

Summary of Forty Recommendations

The Forty Recommendations set out the basic framework for anti-money laundering efforts and they are designed to be of universal application. They cover the criminal justice system and law enforcement, the financial system and its regulation, and international co-operation. It was recognized from the outset of the FATF that countries have diverse legal and financial systems and so all cannot take identical measures. The Recommendations are therefore the principles for action in this field, for countries to implement according to their particular circumstances and constitutional frameworks allowing countries a measure of flexibility rather than prescribing every detail. The measures are not particularly complex or difficult, provided there is the political will to act. Nor do they compromise the freedom to engage in legitimate transactions or threaten economic development.

The Recommendations are grouped into the following broad categories:

A. General Framework of the Recommendations

- ✓ Each country should take immediate steps to ratify and implement the Vienna Convention.
- ✓ A country's financial secrecy laws should not prohibit or impede - the implementation of the Recommendations.
- ✓ There should be multilateral cooperation and mutual legal assistance and extradition in money laundering investigations and prosecutions.

B. Role of National Legal Systems in Combating Money Laundering

- ✓ Money laundering should be criminalized and expanded from narcotics to all serious crimes generating substantial proceeds.
- ✓ Legal entities as well as individuals should be subject to criminal liability.
- ✓ Measures should be instituted to provide for the confiscation of property laundered, proceeds from and instrumentalities used or intended to be used in the commission of a money laundering offense.

⁸ Ibid.

C. Role of Financial System in Combating Money Laundering

- ✓ FATF Recommendations should apply to bank and non-bank institutions such as bureaux of exchange and to financial activities of non-financial businesses engaged in commercial activities.
- ✓ Strong customer identification and record keeping rules should be adopted.
- ✓ Steps should be undertaken to verify or determine a customer's true identity or on whose behalf transactions are conducted.
- ✓ Records of transactions should be maintained for at least five years.
- ✓ No anonymous or fictitious accounts should be maintained.
- ✓ There should be increased diligence of financial institutions for unusual large or suspicious transactions and prompt reporting to authorities as warranted.
- ✓ Financial institutions, their directors, officers and employees should have a safe harbor for disclosing information to authorities as required by law or regulation.
- ✓ Financial institutions should develop programs against money laundering that include policies, procedures and controls, ongoing training of employees and an audit function to test the system or program.
- ✓ FATF Recommendations should apply to the extent possible to branches of financial institutions abroad. Where this is not possible, special attention should be paid to transactions conducted in these branches to identify suspicious or questionable transactions.
- ✓ Cross border monitoring of cash and bear negotiable instruments should be implemented.
- ✓ A central depository for currency and suspicious reports should be created.
- ✓ Bank and non-bank supervisory organizations should ensure financial institutions have money-laundering programs in place.

D. Strengthening of International Cooperation

- ✓ Information concerning international flows of cash should be recorded and shared to enable estimated of flows and reflows can be made from sources abroad.

- ✓ Information concerning trends and techniques should be disseminated.
- ✓ Suspicious transaction information should be shared “upon request”.
- ✓ International cooperation should be supported by bilateral and multilateral treaties and agreements to facilitate detection, investigation, prosecution, extradition of defendants and the seizure or confiscation of property involved in or traceable to money laundering.

Summary of the Terrorist Financing Recommendations

At a Plenary on the Financing of Terrorism in Washington, D.C. on October 29th and 30th the FATF expanded its mission beyond money laundering. It now focuses its energy and expertise on the worldwide effort to combat terrorist financing. FATF issued new international standards to combat terrorist financing with the goal of denying terrorists and their supporters’ access to the international financial system.

These recommendations require immediate steps to ratify and implement all relevant United Nations instruments, criminalize the financing of terrorism, terrorist acts and organizations, freeze and confiscate terrorists’ assets, report suspicious financial transactions linked to terrorism, cooperate with and assist other countries in the fight against terrorism, regulate alternative remittance systems, impose stronger customer identifications standards, and ensure that nonprofit and other entities can not be used to support terrorist activity.

The FATF will require member countries to be in compliance with the new regulations by June 2002 and have action plans addressing those recommendations not already in place

Indonesia - The Next Phase

Recommendation I. - Financial Intelligence Unit

Indonesian law provides for the creation of a Center for Financial Reporting and Analysis (PPATK). This center or Financial Intelligence Unit (FIU) can be the linchpin of money laundering enforcement and regulation by becoming the central depository of currency and suspicious transaction reports, coordinating law enforcement and regulatory efforts at the national and international level, providing financial analysis and investigative training, and providing guidance and training to financial institution regulators and employees in the law and suspicious transaction reporting.

One problem is the recently passed Indonesian law establishes a reporting level for currency transactions at \$50,000. This unusually high reporting threshold will obviously place critical importance on getting financial institutions to recognize and report suspicious transactions, especially where the transactions are less than \$50,000, if any useful information is to be derived from the reporting requirements. Failure to place emphasis on suspicious reporting could result in significant currency

transactions and criminal activity going unreported. Most countries have reporting thresholds of \$10,000.

The newly established FIU should become a member of the worldwide network of Financial Intelligence Units known as the Egmont Group. The Egmont Group⁹ provides training and technical assistance to countries around the globe in the development and operation of Financial Intelligence Units and the formulation and implementation of counter-money laundering strategies.

An FIU can best be described as a central office that receives disclosures of financial information, analyses or processes them in some way and then provides them to appropriate government, law enforcement and regulatory authorities in support of a national and international anti-money laundering effort. In 1996, there was less than a handful of FIUs in the world. Today there are 58 jurisdictions that comprise the Egmont FIUs from all over the world. The FIUs have developed a network that allows the rapid exchange of intelligence and case related information to combat money laundering as well as terrorist financing.

Named after the venue in Brussels where the first such meeting of FIUs was held in June of 1995, the Egmont Group serves as an international network, fostering improved communication and interaction among FIUs in such areas as information sharing and training coordination. The goal of the Group is to provide a forum for FIUs around the world to improve support to their respective governments in the fight against financial crimes. This support includes expanding and systematizing the exchange of financial intelligence information, improving expertise and capabilities of personnel employed by such organizations, and fostering better and secure communication among- FIUs through the application of technology.

Recommendation II. - Enact or Strengthen Laws to Fight Terrorism

Indonesian law currently does not specifically criminalize the act of terrorism or supporting terrorists organizations. This should be high on the priority list for future legislative development. The passage of a strong money laundering law is a strong first step to combating serious crime. Laws criminalizing acts of terror and support for terrorist organizations must complement the money laundering law to prohibit the use of its financial systems by terrorist organizations. The international consensus to fight terrorist financing has never been stronger. The international community is equipping itself with increasingly more effective tools to prevent and respond to terrorist financing. The Group of Eight (G-8) nations, the United Nations, the European Union, the Financial Action Task Force on Money Laundering (FATF), and the Organization of American States have all sponsored conferences and crafted recommendations designed to produce enhanced cooperation and strengthened measures to combat terrorist financing.

As further evidence of international resolve, on September 28, 2001, the United Nations Security Council (UNSC) adopted Resolution 1373, which reaffirms earlier UN counter-terrorism resolutions and requires states to combat terrorism and the financing of terrorism.

⁹ FINcen Web page. <http://www.ustreas.gov/fincen/>

Recommendation III. - Develop a System of Laws to Govern the Confiscation and Use of Property Derived from illegal Activity.

The new money laundering law (Article 32) provides for freezing of assets reasonably known or suspected to be the proceeds of crime pursuant to a written order of an investigator, public prosecutor or judge. Article 32 requires the financial services provider to freeze the assets and to submit a statement to the ordering authority within one business day of the freezing.

This Article is unclear who is responsible for assets not under the control of the provider of financial services and whether or how they should be confiscated or protected to prevent the removal or placement of assets beyond law enforcement or the courts.

Further, there is no authority in the law providing for how proceeds from confiscated assets can be used or for proceeds from the disposal of these assets to be placed in a centralized fund to ensure proper accounting or sharing either among agencies or organizations within Indonesia or with foreign jurisdictions involved in joint investigations.

Recommendation IV. - Train Enforcement Investigators and Regulators

Intense financial investigations are essential if we are to beat criminals at their trade—whether it's narcotics trafficking, organized crime, money laundering, or bank fraud. Following the money leads to the top of the criminal organization. But financial investigations are extremely complex and difficult to conduct. First, it takes many years of working in the financial industry to understand all its intricacies. Second, no single agency possesses a sufficiently broad or cross-jurisdictional focus and information base to track financial movements. Finally, the sheer size, variety, and pace of change of the financial sector make financial investigations even more difficult. The tools of the money laundered range from complex financial transactions, carried out through webs of wire transfers and networks of shell companies, to old-fashioned, if increasingly inventive, currency smuggling. As soon as law enforcement learns the intricacies of a new laundering technique and takes action to disrupt the activity, the launderers replace the scheme with yet another, more sophisticated method.

Training investigators and regulators is a continuing process to keep abreast of the latest money laundering trends and techniques. Assistance in this area is available from a number of countries and organizations and should be pursued rigorously.

One resource is the Law Enforcement Academy (ILEA) in Bangkok, Thailand, which opened in March 1999. The curriculum and structure of this Academy is similar to the one located in Budapest, except for the shorter duration of the core course and an added emphasis in narcotics matters. Participation is opened to members of the Association of South East Asian Nations and the PRC. Trainers from the United States, Thailand, Japan, Holland, Australia and Hong Kong provide instruction.

Recommendation V. - identify and Understand Alternative Money Remittance Systems

Alternative remittance systems are not regulated in the new law. These remittance systems, sometimes also referred to as informal value transfer systems (IVTS), are a family of monetary remittance systems that provide for the transfer of value outside of the regulated financial industry. These systems should be identified and their operations understood by regulators, law enforcement and in particular providers of financial services if they come in contact with these services. These systems¹⁰ are known by a variety of names reflecting ethnic and national origins, predominantly South Asian and Chinese. They operate throughout the world, especially in countries with large expatriate populations from Africa and Asia. Included, among others, are such systems as hawala (India), hundi (Pakistan), fei ch'ien (China), phoe kuan (Thailand), hui k'uan (Mandarin Chinese), ch'iao hui (Mandarin Chinese) and nging sing kek (Cantonese Chinese). Most of these systems pre-date the emergence of modern banking and other financial institutions. The Colombian Black Market Peso Exchange can also be characterized as a form of alternative remittance system.

These systems provide mechanisms for the remittance of currency or other forms of monetary value—most commonly gold—without physical transportation or use of contemporary monetary instruments. These systems are used extensively as a means for expatriates, such as foreign laborers, to have funds delivered to families in the home country without contact with authorities on either the sending or receiving end. The systems rely on a pairing of brokers, one who orders a disbursement on behalf of a sender and another that makes the disbursement to the receiver, followed at some point in time with a clearing process to settle account imbalances between the brokers. The systems operate on the basis of a trusted relationship established in the context of narrowly defined ethnic and national ties. Records are not typically kept about the identities of the transactors or details of the transactions.

Because of the anonymity and secrecy of the remittance transactions, these systems are known to have been used in a variety of criminal activities including money laundering, terrorist financing, alien smuggling, drug trafficking, arms trafficking, corruption of government officials, currency controls evasion and tax evasion. Although these systems operate outside of the regulated financial industry, they may intersect with banks and other traditional financial institutions in order to either obtain currency needed to make disbursements, or as links in the account clearing process involving wire transfers, imports and exports of goods such as electronics, securities transactions etc. It is at these links that the brokers or their representatives may become known to financial institutions, and their transactions reviewed for indications of unusual activity that require the reporting of suspicious transactions. Again, the high currency threshold of \$50,000 may allow banking transactions of these transmitters to go undetected unless they are identified and reported as suspicious transactions.

¹⁰ International Narcotics Control Strategy Report, March 2001, Money Laundering and Financial crimes, <http://www.state.gov/inl/rls/nrcrpt/2001/rpt/>

Conclusion

FATF money laundering and terrorist financing recommendations are the foundation for implementing anti-money laundering and terrorist financing laws to provide a basis for eradicating or reducing serious crime and becoming a good international partner. Each country must not only continually assess and address its needs for law and policies to address problems unique to its culture and its legal and financial systems, but share information with countries throughout the world to minimize the financing of crime and terrorist activities.

Indonesia now faces a number of challenges. It must aggressively implement and enforce the new money laundering statute, perform regular self-assessments to identify flaws and improvements to the law, and embark on an educational campaign to inform and educate the public, law enforcement, and the financial institution community of its requirements and benefits. The biggest challenge may be one of political will to stay the course and ensure that Indonesia does not provide a haven for criminal activity, which is sure to increase, if anti- money laundering and terrorist financing controls are not rigorously enforced.

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CONFERENCE

on

THE ECONOMIC COST OF TERRORISM: INDONESIA'S RESPONSES

Tuesday, 7 May 2002
Shangri-La Hotel, Jakarta

ASEAN Countries Efforts to Curb Abuses of Their Financial System

KOID SWEE LIAN

Organized by
CENTRE FOR STRATEGIC AND INTERNATIONAL STUDIES
with the support of
USAID



BANK NEGARA MALAYSIA

**ASEAN COUNTRIES EFFORTS TO CURB ABUSES OF
THEIR FINANCIAL SYSTEMS**

7 May 2002, Jakarta

by

Koid Swee Lian
Department Head
Financial Intelligence Unit

AGENDA

- A. BACKGROUND**
- B. INTERNATIONAL INITIATIVES**
- C. REGIONAL INITIATIVES**
 - **Asia / Pacific Group on Money Laundering**
 - **ASEAN Regional Forum**

MONEY LAUNDERING

- A process of converting cash / property which is derived from criminal activities to give it a legitimate appearance
- 3 stages of the process:
 - Placement
The physical disposal of cash proceeds derived from illegal activity
 - Layering
Separating illicit proceeds from their source through transactions that disguise audit trail and anonymity
 - Integration
Place laundered proceeds into normal economy as normal business fund

WHY LAUNDER MONEY?

Today, money laundering has become a critical issue for any significant criminal enterprise. Successful money laundering enables criminals to:

- remove or distance themselves from the criminal activity generating the profits, thus making it more difficult to prosecute key organisers
- distance profits from the criminal activity to prevent them being confiscated if the criminal is caught
- enjoy the benefits of the profits without bringing attention to themselves
- reinvest the profits in future criminal activity or in Legitimate business

THE RISKS OF NOT RESPONDING

- Stability of the banking system
- Increased criminal activity
- Reputational damage
- Ostracism from the international financial system/threat of action (counter-measures) by international community
- Weak link / attractiveness to money launderers
- National security issues

INTERNATIONAL INITIATIVES

UN Political Declaration and Action Plan Against Money Laundering (New York, June 1998)

- (a) Establishment of a legislative framework to criminalise the laundering of money derived from serious crimes in order to provide for the prevention, detection, investigation and prosecution of the crime of money-laundering

UN GA Legislative Framework

- (i) Identification, freezing, seizure and confiscation of the proceeds of crime
- (ii) International cooperation; and mutual legal assistance in cases involving money-laundering
- (iii) Inclusion of the crime of money-laundering in mutual legal assistance agreements for the purpose of ensuring judicial assistance in investigations, court cases or judicial proceedings relating to that crime

UN Political Declaration and Action Plan Against Money Laundering (New York, June 1998)

- (b) Establishment of an effective financial and regulatory regime to deny criminals and their illicit funds access to national and international financial systems, thus preserving the integrity of financial systems worldwide and ensuring compliance with laws and other regulations against money laundering

UN GA Financial and Regulatory Regime

- (i) Customer identification and verification requirements applying the principle of “know your customer”, in order to have available for competent authorities the necessary information on the identity of clients and the financial movements that they carry out.
- (ii) Financial record-keeping
- (iii) Mandatory reporting of suspicious activity
- (iv) Removal of bank secrecy impediments to efforts directed at preventing, investigating and punishing money laundering

UN Political Declaration and Action Plan Against Money laundering (New York, June 1998)

- (c) Implementation of law enforcement measures to provide tools for
 - (i) Effective detection, investigation, prosecution and conviction of criminals engaging in money laundering activity
 - (ii) Extradition procedures
 - (iii) Information-sharing mechanism

ANTI-MONEY LAUNDERING GROUPS

- | | |
|--|-----------|
| 1. Financial Action Task Force (FATF) | est 1989 |
| 2. Caribbean Financial Action Task Force (CFATF) | est 1994 |
| 3. Asia/Pacific Group on Money Laundering (APG) | est 1997 |
| 4. Council of Europe Group (PC-R-EV) | est 1997 |
| 5. The Eastern and Southern African Anti-Money Laundering Group (ESAAMLG) | est 1999 |
| 6. South American Anti-Money Laundering Group (GAFISUD) | est 2001 |
| 7. West African Anti-Money Laundering Group | to be est |

Financial Action Task Force (FATF)

- Set up by the G-7 industrialised countries
- Formulated measures to deter and detect money laundering
- 40 Recommendations – Policy principles to ensure economies are not vulnerable to money laundering
- 8 Special Recommendations on Terrorist Financing
- To facilitate acceptance and Implementation of its recommendations

What Does FATF Do?

- Ensure the adoption of the FATF 40 Recommendations in its member countries and encourage their implementation in other countries
- Evaluate the implementation of anti-money laundering measures
- Monitor developments in international money laundering techniques and develop countermeasures
- Determine the size and nature of the problem of money laundering on a global scale

FATF'S 40 Recommendations

- Legal
Make money laundering an offence & confiscate proceeds of crime
- Financial and regulatory
Prohibit anonymous accounts & procedures to identify & report suspicious transactions
- Law enforcement
International co-operation in investigation, prosecution & extradition

FATF Members

- 29 members

Argentina, Australia, Austria, Belgium, Brazil, Canada, Denmark, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Italy, Japan, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Portugal, Singapore, Spain, Sweden, Switzerland, Turkey, U.K. and U.S.

- 2 International Bodies

European Commission, Gulf co-operation Council

Non-cooperative Countries and Territories (NCCTS)

- FATF has identified list of NCCTs
- NCCTs have critical deficiencies in their anti money laundering systems, or demonstrate unwillingness to co-operate in anti-money laundering efforts

List of NCCTs

(as at 1 February 2002)

- Cook islands
- Dominica
- Egypt
- Grenada
- Guatemala
- Hungary
- Indonesia
- Israel
- Lebanon
- Marshall Islands
- Myanmar
- Nauru
- Nigeria
- Niue
- Philippines
- Russia
- St. Kitts and Nevis
- St. Vincent and the Grenadines
- Ukraine

Countermeasures for NCCTs

- Report any financial transactions with NCCTs to the Financial Intelligence Unit
- Prohibit person/corporation from NCCTs to open account unless holder / beneficiary is identified
- Restrict or impose conditions on financial transactions with NCCTs

Compliance With 28 Key FATF Recommendations (as at April 2001)

| | <u>Compliant</u> | <u>Part Compliant</u> | <u>Non-Compliant</u> |
|-------------|------------------|-----------------------|----------------------|
| Indonesia | - | - | - |
| Malaysia | 10 | 17 | 1 |
| Philippines | 1 | 1 | 26 |
| Singapore | 27 | 1 | 0 |
| Thailand | 22 | 5 | 1 |

Source : The APG Secretariat

REGIONAL INITIATIVES

The APG's 23 members :

- Australia
- Bangladesh
- Chinese Taipei
- Cook Islands
- Fiji Islands
- Hong Kong, China
- India
- Japan
- Macau, China
- Malaysia
- Nepal
- New Zealand
- Niue
- Pakistan
- Republic of Indonesia
- Republic of Korea
- Republic of the Philippines
- Samoa
- Singapore
- Sri Lanka
- Thailand
- United States of America
- Vanuatu

The APG's 13 observer jurisdictions :

- Canada
- France
- Kingdom of Cambodia
- Mongolia
- Palau
- Republic of Kiribati
- Republic of the Maldives
- Republic of the Marshall Islands
- Republic of Nauru
- Union of Myanmar
- Vietnam

The APG's 13 observer international and regional organisations :

- ASEAN Secretariat
- Asian Development Bank
- Commonwealth Secretariat
- Egmont Group of Financial Intelligence Units of the World
- Financial Action Task Force on Money Laundering Secretariat
- International Development Law Institute
- International Monetary Fund
- Interpol
- Offshore Group of Banking Supervisors
- Pacific Islands Forum Secretariat
- United Nations Office of Drug Control and Crime Prevention
- The World Bank
- World Customs Organisation

MISSION STATEMENT

The APG has the following Mission Statement :

Mission

The APG's mission is to contribute to the global fight against money laundering, organised crime and terrorist financing by enhancing anti-money laundering measures in the Asia/Pacific region.

Current Activities

- Mutual evaluations
- Extensive program of technical assistance and training
- Co-operation and provision of information
- Typologies Workshops
- Working Groups on Underground Banking / Alternative Remittance Systems and Information Sharing
- APG Annual Meeting, June 2002

Strategic Plan

The seven goals of the APG are to :

- Develop a better understanding of the nature, extent and impact of money laundering in the region
- Expand regional awareness of money laundering issues and the role of the APG
- Identify and agree on comprehensive anti-money laundering measures appropriate to the region
- Oversee and facilitate the implementation of comprehensive anti-money laundering measures in all member jurisdictions.

Strategic Plan

- Facilitate and coordinate the provision of technical assistance and training to jurisdictions in the region, where necessary, to assist them to implement comprehensive anti-money laundering measures
- Measure the level of implementation by each member of comprehensive anti-money laundering measures
- Facilitate the implementation of the FATF Special Recommendations on Terrorist Financing and the relevant United Nations instruments in all member jurisdictions

COMPARATIVE REGIONAL PROGRESS

Vienna Convention 1988

In 1995, 12 jurisdictions had acceded to, or ratified the Vienna Convention

In 2001, 19 jurisdictions have acceded to, or ratified the Vienna Convention

Anti-Money Laundering Laws (Narcotics Offences)

In 1995, 10 jurisdictions had enacted anti-money laundering laws

In 2001, 20 jurisdictions have enacted anti-money laundering laws, and a further 10 are drafting such laws

Anti-Money Laundering Laws (Serious Offences)

In 1995, 5 jurisdictions had enacted anti-money laundering laws

In 2001, 19 jurisdictions have enacted anti-money laundering laws, and a further 11 are drafting such laws

Suspicious Transactions Reporting

In 1995, 10 jurisdictions had suspicious transaction reporting in place

In 2001, 20 jurisdictions have suspicious transaction reporting in place

Source : The APG Secretariat

SOUTH EAST ASIA

| <u>Jurisdiction</u> | <u>Money Laundering Legislation</u> | | <u>Vienna Convention</u> | |
|---------------------|-------------------------------------|----------------------|--------------------------|-----------------|
| | <u>In Place</u> | <u>Being Drafted</u> | <u>Signed</u> | <u>Ratified</u> |
| Brunei Darussalam | Yes | | Yes | Yes |
| Burma (Myanmar) | No | Yes (Bill) | Yes | Yes |
| Kin. Of Cambodia | No | - | No | No |
| Rep. of Indonesia | Yes | | Yes | Yes |
| Lao PDR | No. | - | No | No |
| Malaysia | Yes | | Yes | Yes |
| Rep. Philippines | Yes | | Yes | Yes |
| Singapore | Yes | | Yes | Yes |
| Thailand | Yes | | No | No |
| Vietnam | No | Yes (Bill) | Yes | No |

Source : The APG Secretariat

ASEAN Regional Forum (ARF) – 23 Members

- ASEAN Countries
- Australia
- India
- Canada
- China
- European Union
- Japan
- Mongolia
- North Korea
- New Zealand
- Papua New Guinea
- Russia
- South Korea
- United States of America

ARF Workshop on Financial Measures Against Terrorism, 24-26 March 2002, Honolulu

- ARF Inter-Sessional Group on Confidence Building Measures, 22-24 April 2002, Hanoi
- ARS Senior Officials Meeting, 16-17 May 2002, Bandar Seri Begawan
- ARF Ministers Meeting, July 2002, Bandar Seri Begawan

Draft ARF Statement on Terrorist Financing

- Freezing of terrorist assets
- Implementation of international standards
- International cooperation: Exchange of information and outreach
- Technical assistance
- Compliance and reporting



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THE ECONOMIC COST OF TERRORISM: INDONESIA'S RESPONSES

Tuesday, 7 May 2002
Shangri-La Hotel, Jakarta

Indonesia's Bank Secrecy and Money Laundering

SUTAN REMY SJAHDINI

Organized by
CENTRE FOR STRATEGIC AND INTERNATIONAL STUDIES
with the support of
USAID

Indonesia's Bank Secrecy and Money Laundering^{*)}

By:

Prof. Dr. Sutan Remy Sjahdeini, SH. ^{)}**

Indonesia finally enacted the Law Number 15, Year 2002 on the Criminal Offenses of Money Laundering dated 17 April 2002, State Gazette Year 2002, Supplement State Gazette No. 4191 Year 2002.

In relation with the enactment of the statutes regarding the Criminal Offenses of Money Laundering above, the question raises whether regulations regarding the bank secrecy, stipulated in Law No. 7, Year 1992, revised and added with Law No. 10 Year 1998, will still be valid as it is for investigators, public prosecutors and judges, performing investigations, legal proceedings and examinations of the criminal offenses of money laundering. This question arises due to one of the factors leading to flourishing practices of the criminal offenses of money laundering in a certain country and the difficulty of combating successfully these practices is due to the tight bank secrecy prevailing in the related country.

The regulation of Indonesia's bank secrecy is provided in Chapter VII and Chapter VIII Article 40 until Article 45, Article 47 and Article 47A of the Banking Law, i.e. Law Number 7 Year 1992 regarding Banking as revised by Law No. 10 Year 1998.

According to Article 40 of the Banking Law, the bank is obligated to keep information confidential regarding its client and its client's deposits. According to Article 40, however, the confidentiality obligation is not without exceptions. Exceptions to the confidentiality obligation are in the following cases:

1. **In the interest of tax collection.** According to Article 41 the Central Bank of Indonesia is authorized to issue at the request of the Minister of Finance a written order to the bank releasing information and disclosing written evidence and statements regarding the financial condition of the client to officials of the Tax Office.

^{*)} This Paper is presented in a Two-days Seminar with the topic: *The Economic Cost Of Terrorism: Indonesia 's Responses*, which was organized by the CENTRE FOR STRATEGIC AND INTERNATIONAL STUDIES in cooperation with the Partnership for Economic Growth (PEG), on 7-8 May 2002, at Shangri-La Hotel, Jakarta.

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2. **In the interest of debt settlements handed over to the *Badan Urusan Piutang dan Lelang Negara* / *Panitia Urusan Piutang Negara*** (Agency for Debt Affairs and State Auction / the Committee for State Debts). According to Article 41A, the Central Bank may authorize officials of *Badan Urusan Piutang dan Lelang Negara* / *Panitia Urusan Piutang Negara* (Agency for Debt Affairs and State Auction / the Committee for State Debts) to obtain information from the bank regarding the Debtor's deposits.
3. **In the interest of the Court proceeding in a criminal case.** According to Article 42, the Central Bank in the interest of a court proceeding in a criminal case may authorize the police, the public prosecutor or the judge to obtain information from the bank regarding the suspect or the accused at the bank.
4. **In a civil court case between the bank and its client.** In accordance with Article 43, in the event of a civil court procedure between the bank and its client, the bank's Board of Directors may inform the Court regarding the client's financial condition and disclose other relevant information to the case. In order to present this information, the bank's Board of Directors does not require obtaining approval from the Central Bank.
5. **In the case of the exchange of inter-bank information.** According to Article 44, in the case of exchange of inter-bank information, the bank's Board of Directors may exchange information regarding the financial position of the bank's client with another bank. To offer this information the bank's Board of Directors does not require obtaining approval from the Central Bank. This matter is in accordance with the universal banking practices, whereby in offering information to another bank, the bank in question does not require obtaining prior approval from whichever authority or from its client.

These exceptions are of a limited nature. This means that, aside of the five points mentioned above, the bank is not allowed for whichever reason, to release information to whoever regarding the client and his deposits. The number of exceptions may only be expanded, if these additional exceptions are incorporated in the banking law or regulated in other statutes.

In accordance with the stipulations of Article 47 of the Banking Law, violations against the secrecy obligation may cause the official or bank employee in concern an imprisonment sentence of minimum 2 (two) years and maximum 4 (four) years and a fine of minimum Rp. 10,000,000,000 (Ten billion Rupiah) and maximum Rp. 200,000,000,000 (Two hundred billion Rupiah). This imprisonment and fine coercion is not characterized as an alternative, but cumulative.

The law makers of the Law on the Criminal Offenses of Money Laundering realize that the extermination of the money laundering practices in Indonesia can not be effective should the bank secrecy still be applicable as meant in the said Banking Law against law enforcers, i.e. the police, office of the public prosecutors and judges performing the investigations, legal proceedings and examinations of the criminal offenses of money laundering. Only if an exception on the bank secrecy is applied to those law enforcers the extermination of money laundering can be of optimal success.

Due to this reason Law Number 15, Year 2002 on the Criminal Offenses of Money Laundering, offers the special facility to the police, the public prosecutor or judge, which is the exclusion from the provisions of the bank secrecy. This special facility is stipulated in Article 33 of the said law.

According to Article 33, par. (1) of the Law on the Criminal Offenses of Money Laundering, in the interests of investigating the criminal offenses of money laundering, the investigator, the public prosecutor or judge is therefore authorized to request information from the financial services provider regarding its client's property, as reported by the *Pusat Pelaporan dan Analisis Transaksi Keuangan* (Center for Financial Reports and Transaction Analysis), the suspect or the accused. According to Article 33, par. (2) in requesting the information as meant in par. (1) the provisions of the statutes stipulating the bank secrecy and secrecy of other financial transactions are not applicable against the investigator, public prosecutor or judge.

According to the Law on the Criminal Offenses of Money Laundering, "the financial services provider" is every natural person or legal body providing financial services, including but not limited to banks, financial institutions, stock-exchange companies, holders of mutual funds, custodians, mandatory, saving and settlement institutions, foreign exchange traders, pension funds and insurance companies. The term "property" is hereby referred to the movable and immovable, tangible as well as intangible goods. In other words, this includes also deposited funds in the bank.

In relation with provisions of Article 33 of the Law on Criminal Offenses of Money Laundering explained above, therefore nor the police, public prosecutor or judge, whilst performing investigations, legal proceedings and examinations on criminal offenses of money laundering, would require approval from anyone in obtaining information from the bank regarding its client and his deposits at the bank. The request for information, however, must be submitted in writing (Article 33, par. (3)). The request letter to obtain such information should not only be sufficiently signed by the police, performing the investigation, or by the public prosecutor being the public prosecutor in question regarding the money laundering case, or by the judge examining the case in question, but according to the stipulations of Article 33, par. (4) the letter of request must be signed by:

- a. The Head of the Regional Police if the request is filed by the investigator.
- b. The Head of the Public Prosecutor Office if the request is filed by the public prosecutor.
- c. The Chairman of the Panel of Judges, examining the case in question, if the request is demanded by the Court.

In addition to Article 33, par. (2), according to Article 14, the said law also releases the bank from the provisions of bank secrecy in performing its obligation to report to the *Pusat Pelaporan dan Analisis Transaksi Keuangan* (Center for Financial Reports and Transaction Analysis). Whereas Article 27, par. (3) of the said law releases the *Pusat Pelaporan dan Analisis Transaksi Keuangan* (Center for Financial Reports and Transaction Analysis) in the case of the *Pusat Pelaporan dan Analisis Transaksi Keuangan* (Center for Financial Reports and Transaction

Analysis) regarding the validity of the bank secrecy provisions, it would therefore be impossible for the bank and the *Pusat Pelaporan dan Analisis Transaksi Keuangan* (Center for Financial Reports and Transaction Analysis) to perform their duties optimal.

Therefore, with the enactment of the Law on Criminal Offenses of Money Laundering, the initial 5 (five) exceptions as determined by the Banking Law, has now increased to 7 (seven), i.e. the increase of the 2 (two) exceptions based on the Law on Criminal Offenses of Money Laundering.

The provisions of Article 33, par. (2), Article 14 and Article 27, par. (3) of the Law on Criminal Offenses of Money Laundering is an additional exception towards the regulation on bank secrecy as provided in the Banking Law and is considered. a penetration against the very thick and strong wall of bank secrecy. The incorporation of the provisions of Article 33, par. (2) in the Law of Criminal Offenses of Money Laundering is considered a reflection of the serious and firm attitude of the Indonesian Government and Parliament to combat the criminal offenses of money laundering in Indonesia.